No. 15,457

In the

United States Court of Appeals

For the Ninth Circuit

Securities and Exchange Commission,
Appellant,

vs.

Insurance Securities Incorporated, et al.,
Appellees.

Brief for Appellees Insurance Securities Incorporated, Abe P. Leach, Ossian E. Carr, Arthur J. Lonergan, Roy A. Haight and Leland M. Kaiser.

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SECURITIES AND EXCHANGE COMMISSION, *Appellant,*

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This is an appeal (R. 152) from a judgment of dismissal (R. 151), rendered on a motion to dismiss an amended complaint (R. 52). *Securities & Exchange Commission v. Insurance Securities Inc.,* 146 F.Supp. 778. The suit was brought by an administrative agency seeking to enforce its own peculiar notions of public policy without the slightest basis in the statute on which it purports to rest. At the outset of the argument in the Disrict Court we submitted "our view, that the plaintiff's foundation and basic contention is about as fantastic an assertion as has ever been presented in a court" (R. 157), and we make the same submission at the outset here.

STATEMENT OF THE CASE

The plaintiff and appellant is the Securities and Exchange Commission, hereafter called the Commission or the S.E.C. It purports to proceed under the *Investment Company Act of 1940* (15 U.S.C. § 80a-1, et seq.), hereafter called the Act or the statute.[1]

The prime question in the case is simply this: Does anything in the statute prohibit the actions alleged in the complaint? Did Congress see fit to confer on the Commission any authority to seek from the courts condemnation of what was done or any jurisdiction on the courts to grant it?

A. The defendants and their relation to each other.

1. The Trust Fund:—The Investment Company.

There exists in Alameda County, California, a certain unincorporated "Trust Fund", created by a trust agreement in 1938 (R. 5, para. 5) with a San Francisco bank as trustee (R. 22). The assets of the Trust Fund are supplied by "investors" and in turn are invested by the Trust Fund in a variety of insurance company stocks (R. 5, para. 7). As the complaint correctly alleges (R. 5, para. 5, 6), the Fund is a "registered investment company" within the definitions of the Act.[2] While the Fund was named as a defendant, no charges were made against it, no relief was sought against it, and it never appeared in the action. Although it is named in the caption, in this Court, as one of the appellees, the terms "appellees" and "defendants" will be used in this brief to refer to the other defendants alone.

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1. In this brief we shall cite the sections of the Act merely as "Section ....". The comparable section in Title 15 U.S.C. will ordinarily be prefaced by "80a". E.g., "Act, Section 3" will be found as 15 U.S.C. Sec. 80a-3, and "Act, Section 15" will be found as 15 U.S.C. Sec. 80a-15. Some sections of the Act bear a different number in 15 U.S.C. 80a, and when this is so, we shall also give the U. S. Code citation.

All emphasis in quotations in this brief has been added unless otherwise noted.

2. Act, §§ 3, 8. Section 3 states that an "investment company" is an "issuer". Section 2(a)(21) defines an "issuer" as every "person" who issues a security. Section 2(a)(27) defines "person" as including "company", and Section 2(a)(8) defines "company" as including a "trust, a fund".

2. ISI:—the Service Corporation.

Appellee Insurance Securities Incorporated is a California corporation organized in 1938 (R. 4, para. 1), and it will hereafter sometimes be referred to as "ISI". ISI has had a *contract* with the Fund, the latter acting by the vote of the investors. Under this contract ISI performed three types of services for the Fund: (a) It acted as a salesman to sell "Participation Agreements" in the Trust Fund to investors; (b) as investment adviser it selected the insurance stocks the Fund should buy; and (c) it performed administrative duties.

For convenience we shall refer to the contract between the Fund, on the one hand, and ISI, on the other, as the "service contract". We shall sometimes refer to ISI as the "Service Corporation"[3] and to the duties performed by it under the contract as the "services".

As compensation for its several services ISI is paid certain fees as provided by the contract,[4] which are of three types comparable to the three types of service. The bulk of the fees are called "creation fees" and consist of commissions paid for the sale of participations to investors (R. 6, para. 9). These sums are paid by a deduction from the amounts paid to the Fund by the individual investor (R. 31, 32, para. (e)). Of minor amount is an "administrative fee", and of even smaller amount is an "advisory fee", based on the net payments of investors (R. 6, 29, 30).

There is no question that a contract between a "service corporation" and an "investment company" for the performance of such services and the payment of the fees for services rendered is recognized by the Act (cf. pp. 12, 61, 64 below).

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3. In the language of the Act, ISI is the "Sponsor, Depositor, Investment Adviser and Principal Underwriter" of the Fund (R. 5, para. 4). For convenience we shall refer to any corporation performing similar services as a "service corporation" and to any contract for similar services as a "service contract".

4. It may be observed that no contention is made that these fees are unfair in amount.

3. The individual defendants Leach, Lonergan, Carr and Haight:—Stockholders in the Service Corporation.

None of the individual defendants was, at any time referred to in the complaint, an officer, director or employee of the Trust Fund. Being a corporation, ISI has its own stockholders, and defendants Abe P. Leach, Ossian E. Carr, Arthur J. Lonergan, and Roy A. Haight were some of ISI's stockholders and directors (R. 4, para. 2; R. 7, para. 14).

The remaining defendant, Leland M. Kaiser, is in still a different category and his position in this case is described at p. 16, *infra.*

4. Relationship of the parties to each other—the Chart.

So that the relationship of the several parties to each other may be clear, we reproduce a schematic chart used in the argument below. The relationship may be summed up thus: Leach, Lonergan, Carr and Haight were stockholders in the corporation, ISI, and were several of its directors. ISI had a contract with the Trust Fund, whereby it performs services for the Fund and receives compensation. The Trust Fund is a fiduciary to its investors.

When in this brief we refer to "stockholders," we mean stockholds in ISI; by "investors" we refer to investors in the Trust Fund.

B. The proceedings below.

On August 13, 1956, the Commission filed its complaint in two counts (R. 3-47) and with only casual oral notice applied for a temporary restraining order.[5] In view of the lack of adequate notice, defendants stipulated to a limited interlocutory restraining order, and the application for an injunction *pendente lite* was set down for hearing (R. 48-50). Thereupon defendants filed their

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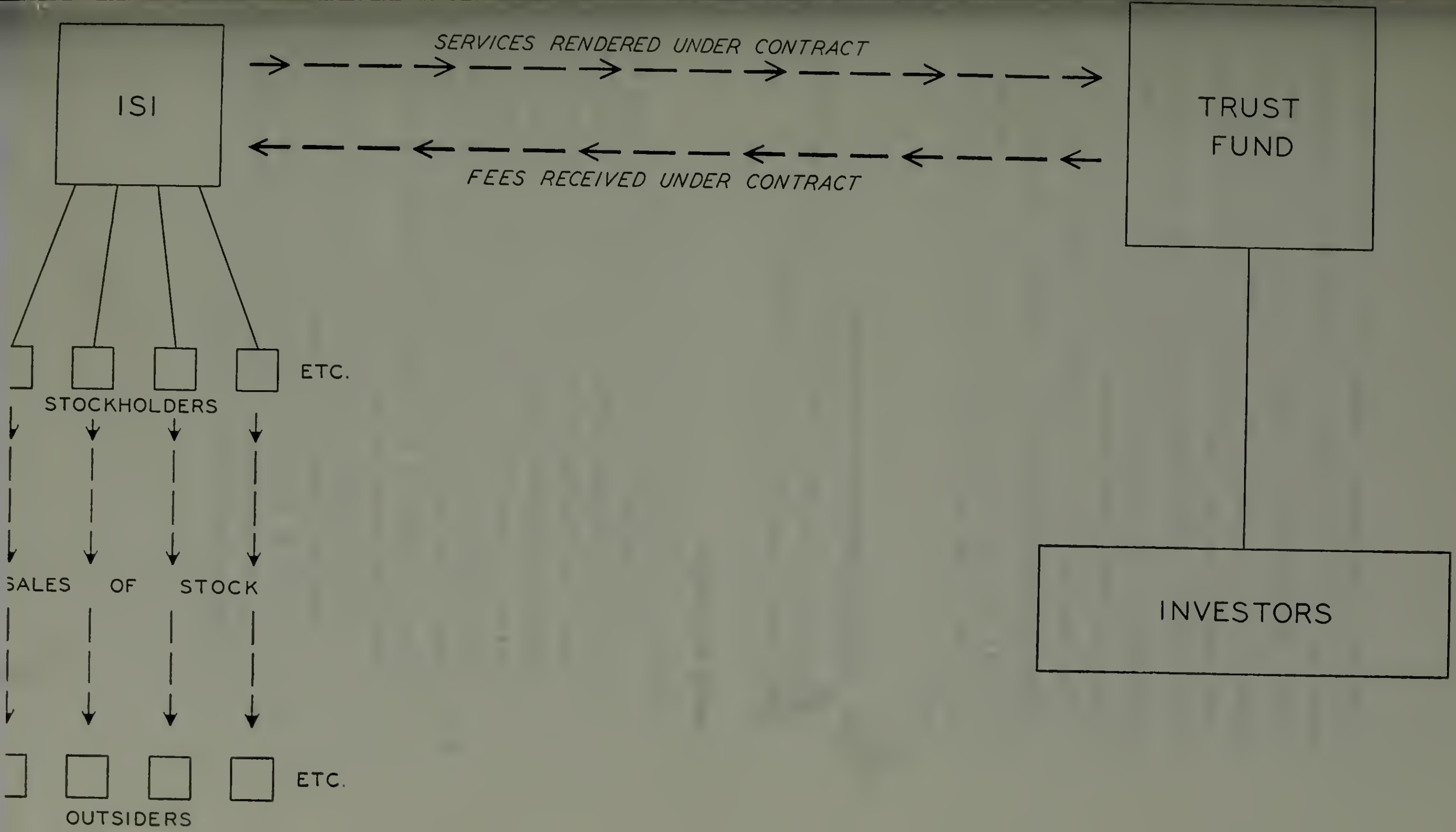
5. Appellant's brief loosely states that "On August 14, 1956, the Commission brought on for hearing its motion for a preliminary injunction * * *" (Br. 13). This is not a correct characterization of what happened.


SERVICES RENDERED UNDER CONTRACT
FEES RECEIVED UNDER CONTRACT
ISI
TRUST
FUND
INVESTORS
STOCKHOLDERS
ETC.
SALES OF STOCK
OUTSIDERS
ETC.

"Motions to Dismiss and Dissolve" (R. 52), to be heard on the same date as plaintiff's application, and by that motion sought to dissolve the interlocutory restraint and also to dismiss the complaint. Before defendants' motions or plaintiff's application for an interlocutory injunction could be heard, a stipulated "Second Interlocutory Order" dissolved the restraining order and withdrew the application for an interlocutory injunction (R. 93). The proceedings for an interlocutory injunction thereby became moot.

The motion to dismiss was argued at great length (R. 155) and granted upon the allegations of the complaint, with an opinion (R. 142-150). The gist of the opinion is that there is no authority in any statute for the suit. An order of dismissal followed (R. 151, 152).

C. The claim asserted in the first count.

Count One is the main count of the complaint, and the Commission rests it entirely on Section 36 of the Act.

Section 36 of the Act.

Section 36 [15 U.S.C., Section 80a-35] provides:

> "The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:
>
> "(1) as officer, director, member of an advisory board, investment adviser, or depositor; or
>
> "(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

> If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate."

No mismanagement or misappropriation is charged.

The gist of Count One is the claim that certain defendants had committed a "gross abuse of trust" or "gross misconduct" *with respect to the Trust Fund*. The very first sentence of the complaint so asserts (R. 3). It is therefore notable that, in response to a request for admission under R.C.P. Rule 36, the Commission admitted (R. 50, 89)

> "that the action does not concern the investments in insurance stocks nor the portfolio of the Trust Fund, nor the manner in which Insurance Securities, Inc., has managed the funds invested in Trust Fund.
>
> "The complaint does not allege that the defendants have mismanaged or misappropriated any of the assets of the Trust Fund."

As the District Court said in its opinion (R. 147):

> "The complaint makes no charge of any misconduct or abuse of trust, gross or otherwise, with respect to Trust Fund or its investors. No claim has been made in the complaint or otherwise that the business of Trust Fund has not been conducted efficiently or honestly or that the investors of Trust Fund have suffered any loss or damage of any kind with respect to their interest in Trust Fund by reason of any act or conduct of Service Company, or its officers or directors."

And this statement is not challenged by appellant. Thus at the outset it is seen that in this case the Commission uses the term "gross abuse of trust", not in any normal sense, but in an esoteric sense of its own.

Sales by stockholders in ISI to outsiders of their stock in ISI.

The claim is that a "gross abuse of trust" occurred because the defendants Leach, Lonergan, Carr and Haight *sold some of their personally owned stock in ISI to third parties at certain prices.*

On January 1, 1956, each of these 4 individuals owned 30,000 shares of stock *in ISI* out of a total of 166,000 shares outstanding (R. 7, para. 14). The complaint alleges that thereafter, and prior to the institution of the action, by a number of sales at different times and to a number of different buyers, Leach, Lonergan, Carr and Haight each sold 13,000 shares (R. 9, para. 18).[6] In July, defendant Leach entered into a contract to sell 16,000 additional shares (R. 59, 65, 67), to be consummated either on the day a new contract between the Trust Fund and ISI was approved by the investors or, if the new contract was rejected, then within 7 days after rejection (Exhibit B to Complaint, at R. 33; also R. 68). The sale had not been consummated when the complaint was filed. The first "Interlocutory Order" issued on August 14th restrained the voting by the investors, so that the consummation of the sale was prevented until a later date.[7] Relevant data as to the number of different sales, the dates, the buyers and the like will be stated in the division of the argument below where it is pertinent (pp. 94-96, *infra*).

None of the purchasers in any of the sales is a defendant.

Like any service corporation, ISI's *physical* assets are relatively small, and the complaint alleges that the net asset value of its shares, as shown on the balance sheet, was $1.81 per share (R. 9,

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6. Following the practice of the complaint, the number of shares is here stated in terms of equivalents after a splitup (R. 7, para. 13).

7. The record shows that after dissolution of the restraining order on August 30th (R. 93), the investors approved the new service contract between ISI and the Fund (R. 140, 141). The record does not show whether the July contract by Leach to sell the 16,000 shares was then consummated, but we admit that it was.

para. 19). But as in the case of any service organization, physical asset value is no measure of worth, and the various sales in 1956 were made at the price of $50 per share (R. 9).

The Commission points (Br. 7) to Section 2(a)(9) of the Act which provides:

> "Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company. * * *"

It then argues that the individual defendants—Leach, Lonergan, Haight and Carr—sold a "controlling block" of stock. *If* all the stock sold in 1956 by these four were deemed sold by one seller to one purchaser, there would have been a transfer of control *of ISI,* the "Service Corporation".

As we shall see (pp. 94-96, *infra*), the uncontradicted fact is that not a single stockholder of ISI owned as much as 25% of its stock, nor did a single stockholder sell all he had to one buyer. Not one had a controlling block to sell and no buyer bought as much as 25%. Consequently, in order to present its theory, the Commission found it necessary to aggregate all the sellers and all their sales, on the one hand, and all the buyers and all their purchases on the other. The manner in which it attempts to do this is described in Part Two of the argument relative to Count One (p. 97, *infra*).

Nature of appellant's claim.

Starting with the assumption that a "controlling block" of stock *in ISI* was sold, the Commission adds the fact that the price was $50 per share. It is these two facts which the Commission contends constituted the alleged "gross abuse of trust"—not toward other stockholders of ISI—but toward the investors in the Trust Fund.

As we understand the contention, had the selling stockholders of ISI not been directors of that corporation, there would be no "gross abuse of trust" regardless of the number of shares sold or the price.[8] This restraint in the Commission's contention is imposed on it by the fact that it rests its case on Section 36 of the Act. By its terms Section 36 is limited in scope. It applies only to the investment adviser or principal underwriter of an investment company and to one who is a director or officer of the investment company. And the remedy it prescribes is an injunction against activity in one of the prescribed categories. Even the Commission cannot find in Section 36 any basis to reach stockholders of an adviser and underwriter, if they are not directors or officers and *occupy no office subject to an injunction.*

In consequence, in fashioning its theory on Section 36, the Commission reaches a curious result (Cf. App. Br. 68):

1. A stockholder of a service corporation who is not a director may sell any number of shares at any price whatsoever.

2. A stockholder who is also a director may sell a block of 25% or less of the stock for any price, however large, but he may not sell a block of more than 25% for more than asset value.

3. A director who owns all the stock may sell it all in equal blocks to 4 unrelated buyers at any price per share, but he may sell to 3 unrelated buyers in equal amounts only at physical asset value.

4. A director may give or bequeath any amount of his stock to whomever he pleases.

In the Argument to follow we shall ask the Court to draw the obvious conclusion that an attempt to deduce a regulation of the price at which stock in a service corporation may be sold, and to work the odd distinctions noted above, from a section of the Act

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8. As the complaint alleges (R. 9, para. 18), 20,000 shares of ISI stock were sold by several others who were not directors, and no claim is made against them.

that neither refers to directors or stockholders of *that* company nor speaks of sales or prices, is fantastic.

The nature of the Commission's claim, as asserted in Count One, may further be characterized from its allegations and admissions as follows:

1. The transactions—the sales of stock *in ISI* by *its* stockholders—were "transactions * * * with outsiders and *not with the Trust Fund*".[9] *That is, here is no case of those in control dealing with their beneficiaries;*

2. There was no transaction between the Trust Fund and the Service Corporation. No defendant bought anything from, or sold anything to, the Trust Fund;

3. "There was no diversion or use of trust assets";[9]

4. ISI did not waste the assets of the Trust Fund;

5. It did not mismanage the Trust Fund (R. 89);

6. It did not appropriate any of the assets of the Trust Fund (R. 89); and

7. Appellant is "not suggesting that the new controlling interests in ISI will abuse their fiduciary position with respect to the Trust Fund" (App. Br. 80).

The claim against defendant ISI.

ISI, the corporation, was not a seller of any stock. While it was named as a defendant in the caption (R. 3), the original complaint nowhere charged it even with the conclusion of misconduct or abuse of trust. The opening sentence of the original complaint read thus (R. 3):

> "It appearing that the *defendant individuals* named hereinafter have engaged, and may continue to engage, in acts and practices which constitute gross misconduct and gross

9. The quoted words come from appellant's brief in the District Court; it has pruned its brief in this Court of a number of such candid statements.

abuse of trust within the meaning of Section 36 of the Investment Company Act of 1940 ('the Act'), 15 U.S.C. 80a-35; * * * the Securities and Exchange Commission ('the Commission') brings this action to enjoin such acts and practices and further violations of the Act and the Commission's Rules and Regulations thereunder, and for other appropriate and equitable relief."

And the climactic (although conclusory) allegation of the original complaint read thus (R. 11, para. 25):

"By reason of the foregoing, the *director-defendants* are guilty of 'gross misconduct' and 'gross abuse of trust' within the meaning of Section 36 of the Act."

It was only as an *afterthought,* by an amendment to the complaint (R. 47), that these two passages were amended to insert the words "Insurance Securities Incorporated and" before the words "the defendant individuals named hereinafter" in the first sentence and to make a similar addition in Paragraph 25. But while the complaint was amended to add the legal conclusion, it was not amended to allege that ISI had done any acts. Furthermore, no final relief was prayed for against ISI in the original complaint, that prayer being added by amendment (R. 47, 48).

D. Execution of a new service contract and other material events in September 1956.

Section 15 of the Act requires any service contract to provide for its automatic termination upon any assignment. In conformity with the Act, the Service Contract between ISI and the Trust Fund provided for such automatic termination (R. 6, 7, para. 11). Section 2(a)(4) of the Act provides that an "assignment" is deemed to include

"any direct or indirect transfer * * * of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; * * *"

If the various sales of ISI stock which occurred or were contracted for prior to the suit constituted a transfer of a controlling block, then the service contract terminated. Because of the possibility that it might be deemed that a transfer of control of ISI had occurred, ISI notified the investors in the Trust Fund that the transfers may have terminated the contract, and it placed before them for vote the question whether the contract should be reinstated. Proxies were solicited for the purpose of voting on this subject. The proxy solicitation material is attached to the complaint (Ex. B; R. 18-47).

The question of reinstatement of the service contract was to be voted upon on August 15, 1956. But this suit was filed on August 13th, and on August 14th the first Interlocutory Order restrained the voting of the proxies on this matter until further order of the court (R. 48). The restraint was dissolved on August 30th by the Second Interlocutory Order (R. 93), and on September 14, 1956, at an adjourned meeting, the investors voted to reinstate the service contract (R. 141). On September 17th, pursuant to this authorization, a *new* service contract between ISI and the Trust Fund was entered into (R. 141).

Creation of a Board of Directors for the Trust Fund.

Prior to September 17, 1956, the unincorporated Trust Fund had no Board of Directors (R. 6, para. 8). But, as stated in the opinion of the District Court (R. 143), "Since the commencement of the action, Trust Fund has, by amendment to its bylaws, authorized the creation of a Board of Directors of its own."

At the very time that the question was submitted to the investors whether the service contract should be reinstated, there was also submitted to them, with the same proxy statement, an amendment to the Trust Agreement establishing a separate Board of Directors for the Fund. The letter to the investors forwarding the proxy statement said (R. 19):

"The amendments to be acted upon involve (a) the creation of a Board of Trustees or Directors for the Fund, to be elected by the Investors, to whom Insurance Securities Incorporated will be responsible in its Investment Advisory and Underwriting functions * * *."

The proxy statement said (R. 24):

"In order that the Trust Fund may be managed by a Board elected by the Investors and directly responsible to them, it is proposed that the Trust Agreement be amended so as to provide for a board of trustees to be known as the 'Board of Directors' which would be entrusted with the management of the business and affairs of the Trust. Duties heretofore performed by the Company would thereafter be performed by it, subject to the control, supervision and direction of the Board of Directors."

This proposal came before the investors on August 15, 1956, since the first Interlocutory Order did not enjoin voting on it (R. 48). It was adopted, and it was put into effect on September 17th (R. 140, 141). The present existence of the Trust Fund's own Board of Directors is recognized throughout appellant's brief (e.g., pp. 5, 11, 42 (fn. 31)).

E. The claim asserted in the second count of the complaint.

Count Two of the complaint was a mere appendage or afterthought, contrived to support Count One and to permit the application for interlocutory relief. Count Two was the sole basis of all interlocutory relief sought by appellant.

As just noted, ISI solicited proxies and Count Two sought to enjoin the voting of the proxies. Its gravamen is stated in paragraph 29 (R. 12):

"The aforesaid proxy solicitation material is false and misleading and in violation of Section 20(a) of the Act and Rule N-20A-1 (17 C.F.R. 270.20a-1), which incorporates by reference and makes applicable to registered investment

companies the Commission's proxy rules set forth in Rule X-14A (17 C.F.R. 240.14)."

Since the proxies were voted after the interlocutory restraint was dissolved on August 30th (R. 93), and since the final decree terminated the remaining restraints of the Second Interlocutory Order (R. 152), everything Count Two sought to enjoin has since occurred.

Appellant concedes that Count Two is dependent on Count One, and that if Count One fails Count Two also fails (R. 161, 162; Br. 15, 105).[10] However, Count Two possesses its own independent deficiencies, which will be discussed in Part Two of the Argument (pp. 105 et seq., *infra*).

F. The relief sought by the complaint.

Other than interlocutory relief, which is now moot, the amended complaint prayed for the following relief only:

1. An injunction against the individual defendants serving as officers and directors of ISI or of the Trust Fund (Prayer 1, R. 14);

2. "That an accounting be rendered by the director-defendants in this cause for the inequitable and wrongful profits realized, and to be realized, as a consequence of the sale of their stock of Insurance Securities Incorporated" (Prayer 5, R. 15). Under this prayer it seeks a decree compelling defendants Leach, Lonergan, Carr and Haight to pay to the Trust Fund about $3,276,920, being the difference between the $50 per share they received for the stock and the $1.81 per share of physical asset value (e.g., Br. 12).

3. An injunction against ISI's "acting as investment adviser and principal underwriter of the Trust Fund" (Prayer 1, as amended, R. 47). Under this amended prayer appellant seeks to abrogate the *new* service contract, which the Investors authorized by their vote on September 14, 1956, and to enjoin ISI from hereafter serv-

10. Br. 15:—"This cause of action was dependent on the first".
Br. 105:—"the alleged proxy violation was expressly dependent upon the cause of action under Section 36."

ing as the investment adviser and principal underwriter for the Trust Fund (E.g., Br. 13).

In short, it seeks both to deprive the sellers of the purchase price and to punish the corporation because of the sales, thus also punishing the buyers and the other stockholders who had no part in the transactions which appellant assails.

Appellant nowhere specifies what final relief is now sought under Count Two.

G. The situation as respects defendant Leland M. Kaiser.

Defendant Leland M. Kaiser was made a defendant in a limited capacity. The caption of the complaint designates him as "Leland M. Kaiser as Attorney and Proxy for investors of Trust Fund" (R. 3), and the complaint alleges (R. 4, para. 3) that "He is made a party defendant herein in his capacity as proxy and attorney on behalf of investors of a 'Trust Fund' * * *."

Count One does not purport to state a claim for relief against him. It charges no act by him and no wrongdoing, and its seeks no relief against him.

Mr. Kaiser was joined as a defendant only because Count Two sought to enjoin the voting of proxies, and he was one of the proxy holders. Since the proxies were voted after the interlocutory restraint was dissolved (App. Br. 110), the action against him is moot, for, if any relief were now possible under Count Two, it could be granted without his presence. We think this so self-evident that the Argument will contain no separate discussion concerning Mr. Kaiser.

H. The function of the affidavits, and appellant's departures from the record.

Nine affidavits were filed in support of defendants' motion to dismiss the complaint and dissolve the interlocutory order (R. 55-

87). These were primarily directed to the issue whether the interlocutory restraint should be extended, as sought by the Commission, or dissolved, as requested by defendants. But the motion to dismiss stated that it might also rely on the affidavits (R. 53) and, to the extent that it did so, it would become a motion for summary judgment under R.C.P. Rule 12(b). Of course, the function of affidavits on an application for, or a motion to dissolve, an interlocutory injunction is much broader than on a motion to dismiss. On the former the affidavits are evidentiary, and the court may weigh and choose in order to resolve factual issues. On the latter the affidavits may be examined only to determine whether a genuine issue of fact exists on a material issue. When the proceedings for interlocutory relief became moot, the affidavits assumed the more limited function.

Consequently, at the hearing on the motion to dismiss, defendants advised the court that:

(1) Primarily, they accepted all allegations of fact in the complaint for the purpose of the motion, without any reference to the affidavits, and submitted that as a matter of law no claim for relief was stated,[11] and

(2) that, as a separate and independent reason for dismissing the complaint, they would refer to the affidavits, but, even so, only for certain uncontradicted objective facts.[12]

As shown in the Questions Presented (p. 20, *infra*), two main but independent reasons for dismissal of Count One are discussed by us. The District Court based its decision on the first, and this

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11. R. 158-59. Defendants' counsel said: We "take the fundamental position that taking Count 1 just on its face, accepting all its allegations of fact, it doesn't state a claim for relief" (R. 158)

The complaint is replete with conclusions of law and, naturally, the motion did not admit them. They will be referred to in proper context in the argument infra.

12. R. 158-59. Defendants' counsel said: "* * * I assure your Honor, I don't intend to ask your Honor to decide any factual questions upon affidavits. But there are certain uncontradicted objective facts * * *"

A tenth affidavit (R. 140), filed by appellees, was of this nature.

accepts the allegations of the complaint and does not rest on any affidavits. The second refers to the affidavits but only for certain uncontradicted objective facts.

Much of the material in the affidavits related to the proxy matter, which is the subject of Count Two,[13] in that they bore on whether the Commission's staff had led ISI to believe that the proxy material, which had been submitted to the staff for inspection, was satisfactory. Defendants contended that the material showed that ISI had issued the proxy material in good faith. Since good faith would be pertinent to the kind of relief that would issue *if* a final decree were to go against defendants, it was relevant to the application for an interlocutory injunction. But that phase of the case became moot with the entry of the Second Interlocutory Order. The issue now is simply whether a claim for relief is even stated by Count Two. That, in turn, is simply the question whether the proxy solicitation material violated the S.E.C.'s proxy rule. And that is a question of law determinable on the face of the complaint to which the proxy solicitation material is an exhibit (R. 18-47). Therefore we shall discuss Count Two on the basis of the allegations of the complaint alone and shall ignore appellant's discussion of the affidavits.

In view of the foregoing, it is curious that appellant's Statement of the Case (Br. 3, et seq.) meanders through the affidavits. Uncontradicted facts may pierce as sham an otherwise good complaint. But a complaint that states no claim for relief in its very fundamentals cannot be made good by resort to affidavits. No resort to affidavits can repair the total absence of statutory foundation.

Even more curious, not to say contrary to proper practice and entirely without justification, is appellant's resort to purported facts *wholly outside the record.* Thus it indulges (Br. 78, 79) in

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13. Part III of Haight's Affidavit, R. 76, and three affidavits filed by the appellant, R. 97, 104, 136.

a little narrative about an "uncontested case" the Commission had with the estate of one Gardiner. We shall briefly comment on this matter at p. 102, fn. 12, *infra.* Appellant also attaches to its brief two pretentious but empty appendices (B and C) supposed to be data about numerous investment companies, all compiled from the Commission's files and a variety of other "sources available to us" (i.e., to the Commission) (Br. 54). None of it is in the record; none is of the type of which a court can take judicial notice. There are perhaps 100,000 or more Commission files in which data of this kind may appear.[14] And as a matter of pure chance appellees' counsel can state of their own knowledge that some of the alleged data is erroneous,[15] which necessarily casts doubt on the reliability of the appendices. Moreover, these appendices are obviously incomplete on their face, even on the matters on which they purport to give information.[16]

Were not these extra-record statements utterly irrelevant to this case, we would vigorously object to this method of arguing a case on appeal. As it is, we shall ignore them.

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14. Specifically, there are 57 companies listed in Appendix B, and it is stated that the information is obtained from the annual reports, proxies, prospectuses and registration statements of such companies. That would require the examination of at least 228 files to verify the data. Appendix C covers 150 companies and would require the examination of at least additional 150 files, a total of at least 378 files.

15. For example, the principal underwriter for Chemical Fund, Inc. is a corporation and not a partnership and is the same corporation which is its investment adviser; Tri-Continental Financial Corporation is not, and never was, the investment adviser to Broad Street Investing Corporation, nor to National Investors Corporation, nor to Whitehall Fund, Inc.; Broad Street Sales Corporation is not owned by Tri-Continental Corporation; Broad Street Sales Corporation does have other business than that of acting as principal underwriter for the three investment companies named; de Vegh & Company is not, and never was, the principal underwriter for de Vegh Investing Company, Inc., which, indeed, has no principal underwriter.

16. For example, information is given only as to ownership of 10% or more in some cases and 25% or more in other cases.

THE QUESTIONS PRESENTED

I. With Respect to Count One.

Question 1: Assuming that Leach, Lonergan, Haight and Carr sold a "controlling block" of stock in ISI, nevertheless is any claim for relief stated either against them or ISI? In other words, does the Act regulate the sale by any stockholder of his stock in a service corporation or limit the price? Our basic submission is that it does not, regardless of the number of shares sold. And this is what the District Court held.

Question 2: Does the complaint allege that there was the sale of a "controlling block", and, if it does, has not this allegation been pierced by an uncontradicted factual showing as sham?

II. With Respect to Count Two.

It is conceded that Count Two fails if Count One fails. In addition:

Question 1: Is not Count Two moot in any event?

Question 2: Regardless of Count One, is it not plain on the face of the complaint that there was no violation of the Proxy Rules and that Count Two is frivolous?

SUMMARY OF THE ARGUMENT

I. With Respect to Count One.

A. Count One states no claim for relief, even if a controlling block of ISI stock were sold.

1. A transaction otherwise legal cannot be outlawed or denied its usual busines consequences unless banned by Congress. *Securities and Exchange Commission v. Chenery Corp.,* 318 U.S. 80, 92. But Congress has not, by any express provision in the Investment Company Act, purported to prohibit the sale of stock in a service corporation or to regulate the price at which it may be sold. Congress was concerned with transfers of control of investment companies without the consent of the investors, and prescribed as the remedy that any transfer of a service contract or of the

control of a service corporation terminates the contract, leaving it up to the investors to reinstate the contract or not (Act, Sections 1(b)(6), 15(a), and 2(a)(4)). This is the only protection Congress thought it necessary to give the investors. In view of these express provisions, it is fallacious to talk about sale of "control" of an investment company. No such sale can occur or can ever be effected by transfer of controlling shares in the service corporation. (pp. 28-30, *infra*).

2. Lacking specific statutory support, appellant relies entirely on Section 36. But that section has nothing to do with the subject, and appellant cannot make it do so by resort to "legislative history". The Act is so detailed and precise that it precludes enlargement by implication. *Doyle v. Milton,* 73 F. Supp. 281; *Addison v. Holly Hill Co.,* 322 U.S. 607, 617; *Howard v. Furst,* 238 F.2d 790 (2 Cir.), cer. den. 353 U.S. 937. Furthermore, the Act was a compromise measure agreed on between the Commission and the investment company industry. In the Act as passed, Congress avoided broad standards and delegations of discretion and substituted detailed and explicit prescriptions, demonstrating that when Congress meant to regulate or prohibit it did so explicitly. (pp. 31-42, *infra*).

3. The essence of appellant's position is that it is not satisfied with Congress' answer to the transfer problem, lacks Congress' faith in the competence of the investors to pass on reinstatement of contracts, and belittles Congress' remedy. But when Congress provides a remedy, no one may enlarge it by belittling what Congress has done; the scope of a statute may not be extended beyond the point where Congress has indicated it should stop. *62 Cases of Jam v. United States,* 340 U.S. 593; *Wilder Mfg. Co. v. Corn Products Co.,* 236 U.S. 165, 174; *Bruce's Juices v. American Can Co.,* 330 U.S. 743; *Switchmen's Union v. Board,* 320 U.S. 297, 301. (pp. 42-47, *infra*).

4. Nor can appellant draw its contentions into Section 36 from any principle respecting fiduciaries. To say that a man is

a fiduciary only begins analysis. One must ask to whom is he a fiduciary, what obligations he owes as such, and wherein has he disregarded his obligations. *Securities and Exchange Commission v. Chenery Corp.,* 318 U.S. 80, 85. While ISI was a fiduciary to the Trust Fund, this did not make it a fiduciary in everything it did, and did not make the stockholders of ISI fiduciaries to the Fund with respect to their stock in ISI. **This case involves no self-dealing; no transaction between fiduciary and beneficiary; no diversion, use, waste, appropriation or mismanagement of trust assets; no abuse of fiduciary position with respect to the Trust Fund.** (pp. 47-49, *infra*).

"Gross abuse of trust" and "gross misconduct" as used in Section 36 refer to self-dealing, that is, transactions between officers, directors and similar persons, on the one side, and investment companies with which they are associated, on the other. These terms were intended to cover such substantial deviation from the obligations of trusteeship as show that the person cannot be entrusted with the management of other people's money (Hearings of the Subcommittee of the Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess., on H.R. 10065, p. 59; *Aldred Investment Trust v. S.E.C.,* 151 F.2d 254). And this is confirmed by the fact that Section 36 does not speak of "abuse of trust" but of "gross abuse of trust". (pp. 49-54, *infra*).

Every contract between two parties has two values, one to each party. The value of a service contract to the investment company lies in the fact that it obtains services. The value to the service corporation lies in the fees received. The purchaser of stock in a service corporation may entertain a hope that the investors in the investment company will reinstate the service contract terminated by the sale, but if any value attaches to that expectation and thus to the hope of future fees, it belongs to the service corporation's side of the contract. Thus there is no trading in a trust asset. As the investment company must continue to pay fees, the sale of the service corporation's stock by a stockholder

therein to another person takes away from the investors in the investment company not one cent nor adds one cent to their expense. (pp. 54-57, *infra*).

Corporate fiduciaries who perform services for an agreed fee are common in American law and business, and they are entitled to make a profit. Their stock is freely bought and sold, and like the stock in many corporations the value is fixed in relation to expected earning power. It has never been held that this value is an asset of the beneficiaries who pay the fees that form the earnings. (pp. 57, 58, *infra*).

According to appellant, a sale of stock in a service corporation disregards a fiduciary obligation because of a "conflict of interest" in seeking a price greater than would be obtainable if the service contract were rewritten to reduce the service fees. But there is no duty on the part of a fiduciary to reduce the agreed fees. Any reasoning that would support such a duty would also limit the stockholders in a service corporation to insignificant dividends. In essence, appellant is seeking to set itself up as a rate-regulating agency to fix a service corporation's fees indirectly. But Congress has conferred no such power on the Commission or the Court. (pp. 59-61, *infra*).

Appellant is illogical when it speculates that a price based on earnings induces hazardous policies. The greater the price, the more it is to the interest of the stock purchaser for the service corporation to serve the investment company successfully so as to continue to earn compensation. This is particularly true of ISI, whose fees are based solely on the amount of investors' money attracted into the Fund and not at all on transactions in, or manipulations of, the Fund. (pp. 61-63, *infra*).

The analogy of a sale by the trustee of his office, which appellant tenders, is false. A trustee cannot sell his office at all, but Congress recognized that a corporation may act as an investment adviser and underwriter and that its stockholders may sell their

stock. This is inherent in the concept of a corporate fiduciary, as appellant admits. (pp. 63-65, *infra*).

Appellant's other citations are not relevant. The general rule is that the holder of a controlling block of stock may sell for the best price available, enhanced by the control position of his shares. To this rule appellant's citations merely note exceptions in the case of "looting", misrepresentation, or other special situations. And this subject is not relevant, because it relates to the duty of those in control of a corporation to the corporation itself or to the minority stockholders therein. No case suggests that majority shareholders owe any duty with respect to their shares to outsiders with whom the corporation has a contract. (pp. 65-71, *infra*).

Moreover, under the particular facts of the present case, there is no possibility of any control of the Trust Fund by the purchasers of ISI shares because the Trust Fund now has its own independent Board of Directors. (pp. 71, 72, *infra*).

5. ISI committed no conduct complained of, for that conduct was the sale of stock in ISI, and it was the conduct of the individual stockholders. A "reverse disregard of corporate entity" is not possible because not all the stockholders committed any act claimed to be misconduct, and what was done was done with respect to individual property and not on behalf of the corporation. (pp. 73-77, *infra*).

6. Section 36 is unique and unlike any other section of the Act. As originally proposed, it made acts of gross abuse "unlawful" and hence subject to penal sanctions under Section 49 and to any appropriate civil remedy at the suit of the Commission under Section 42(e). But it was deliberately rewritten by Congress, so as to grant a specific remedy for gross-abuse, limited to an injunction against continuance by the guilty person in the capacity in which he committed it. (pp. 78-81, *infra*).

Hence the Commission has no power to seek an accounting of profits made by the sellers of stock. Hence, also, no court has jurisdiction to grant an accounting at the suit of the Commission,

for the Commission is not an injured party entitled to invoke the full scope of an equity court. It is merely an agency of the government, empowered by Congress to seek a specific remedy and confined within the limits of the Congressional grant. (pp. 81-84, *infra*).

Furthermore, the nature of the remedy under Section 36 demonstrates that the Section has nothing to do with sales of stock in a service corporation. The remedy provided by Congress illustrates the evil it sought to remedy. If transfer of control of a service corporation were deemed to be a gross abuse of trust under Section 36, the only remedy available would consist of ousting the individuals from office and would thereby effectuate the transfer of control. This would be paradoxical. (pp. 84, 85, *infra*).

7. In fact, the individual defendants do not come under Section 36 at all. That section does not relate to persons in all capacities fiduciary to an investment company but solely to *certain* capacities and then only "in respect of" an investment company. The capacities are (a) investment adviser, depositor and principal underwriter of an investment company, and (b) officer or director of an investment company or member of its advisory board. ISI, and not the individuals, is the investment adviser, etc., of the Trust Fund. And the individuals are not officers or directors of the investment company—the Trust Fund—but of ISI. They occupy no capacity to which Section 36 relates.

So far as officers of a service corporation act for it in respect to its duties under the service contract to the investment company, their acts are its acts and can fall under Section 36. Acts as individuals, such as buying or selling to the investment company, are specifically prohibited by other sections of the Act. But acts in their individual capacity of selling their personal property to outsiders come within no section.

The plain English of Section 36 thus confirms the conclusion that it was never intended to reach sales by stockholders of their stock in a service corporation. (pp. 86-93, *infra*).

B. There has been no transfer of a controlling block of stock of ISI.

Appellant's theory assumes that there was a sale of a controlling block of stock in ISI, and in part I we accept this assumption. But it is incorrect.

A "controlling block" means more than 25% of the stock (Act, Section 2(a)(9)). In order for there to be a transfer of a "controlling block", someone must sell more than 25% and someone must buy more than 25%. The matter must be looked at both from the seller's side and the buyer's side. But it is undisputed that no stockholder sold or even owned that much. Conversely, the transfers were made, not to 1, but to 7, none of whom acquired anywhere near 25%. Consequently appellant's brief seeks to aggregate all the sellers and all the buyers. Paragraph 16 of the complaint is the only allegation possibly bearing on that effort (quoted at p. 97, *infra*). But (1) this does not allege that the sellers acted in concert with each other; (2) even if it did, it would not bring this case within the Act's definition of a controlling block, and (3) it does not take account of the buyers' side. While it alleges that the sellers planned to sell to buyers "affiliated among each other through stock ownership and otherwise", the uncontradicted fact is that 4 of the 7 buyers are not affiliated with each other or with the other 3 by stock ownership or in any other way in which affiliation is defined by Section 2(a)(2) and 2(a)(3) of the Act, or in any other way. And the three affiliated buyers acquired in the aggregate less than 25%. (pp. 94-104, *infra*).

II. With Respect to Count Two

A. Count Two is moot.

The purpose of Count Two was to enjoin voting of the proxies, but they have all been voted. No relief by way of abrogating the contract authorized by the vote is available under Count Two. In any event, if appellant is correct in its contentions with respect to Count One, it will obtain that relief there, and Count Two is a superfluity. (pp. 105-106, *infra*).

B. There was no violation of the Proxy Rule.

The applicable Proxy Rule forbids (a) the affirmative but false statement of a material fact, and (b) the omission "to state any material fact necessary in order to make the statements therein not false or misleading." The complaint claims one affirmative misstatement and three items of omission.

The supposed misstatement is that, when ISI informed the investors that "a termination of the [service] contract takes place upon its assignment" and that the "stock sales may be considered an assignment" and therefore solicited the proxies *as if* the contract had in fact terminated, it should have stated that the contract had terminated! This is a frivolous contention, because the difference between what was said and what appellant claims should have been said is the difference between tweedledum and tweedledee. (pp. 106-110, *infra*).

The alleged omissions are the absence of a statement of the price at which the ISI stock was sold, its net book value per share, and the sellers' profits, and the omission to state that ISI had been advised by the staff of the Commission that the change in majority ownership "may also involve gross misconduct and gross abuse of trust under Section 36." Appellant admits that no affirmative statement in the proxy material was a half-truth or misleading because of any of these omissions. Its claim is, simply, that there was "a failure to disclose material information". But the only omissions the Proxy Rule reaches are of facts necessary in order to make affirmative statements not false or misleading. Its provisions are limited to "half-truths" and do not require the soliciting party to state every fact that one "might like to know or that might, if known, tend to influence his decision" (p. 113, *infra*). Moreover none of the omitted facts was relevant to the issue at hand, reinstatement of the contract. (pp. 110-114, *infra*).

PART ONE OF THE ARGUMENT

Discussion of Count One

I.

COUNT ONE OF THE COMPLAINT STATES NO CLAIM FOR RELIEF, EVEN ASSUMING A SALE OF A CONTROLLING BLOCK OF STOCK IN ISI

Rebuking the Commission in *Securities and Exchange Commission v. Chenery Corp.*, 318 U.S. 80, the Supreme Court said (p. 92)

> "* * * But before transactions otherwise legal can be outlawed or denied their usual business consequences, they must fall under the ban of some standards of conduct prescribed by an agency of government authorized to prescribe such standards—either the courts or Congress or an agency to which Congress has delegated its authority."

Under the Act Congress has not delegated any authority to the Commission to lay down any standards on the subject of this case. The simple basic question is therefore this: Has Congress itself purported to regulate the price at which one may sell stock in a service corporation or to prohibit the sale in any circumstances?

A. The Act Does Not Purport to Regulate the Sale of Stock in a Service Corporation Like ISI, or the Price at Which It May Be Sold.

The Act contains no provision which prohibits sales of stock in a service corporation or which limits the price at which stockholders in such a corporation may sell their stock. This first and notable fact appellant is compelled to admit.

1. The express provisions of the Act provide a different kind of treatment, viz., termination of the service contract.

Section 1(b) of the Act states the "national public interest and the interest of investors" which the Act is designed to protect. The

relevant subdivision is (6), which declares that the national public interest and the interest of investors are adversely affected:

> "when investment companies are reorganized, become inactive, or change the character of their business, *or when the control or management thereof is tranferred, without the consent of their security holders;*".

In short, the concern of the Act was that when the control or management of an *investment company* is transferred, the *security holders shall have the right to approve or reject.* To this end there *is a specific provision.* As already noted (p. 12, *supra*), Section 15 requires that any assignment of a service contract automatically terminate it, and Section 2(a)(4) provides that an "assignment" is deemed to include a transfer "of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor * * *."

Thus *the* protection of the Act with respect to transfer of control of a service corporation, and the only provision on the subject, is that the service contract shall terminate, and thereby any question of its renewal must be placed before the investors in the investment company for their determination.

In this case, the protection which Congress provided was enjoyed. As we have seen (pp. 12, 13, *supra*), because of the possibility that it might be deemed that a transfer of control had occurred, ISI did notify the investors in the Trust Fund and placed before them the question whether the contract should be reinstated, and they voted for its reinstatement.

2. No transfer of control of an investment company is possible through transfer of control of a service corporation.

Hence, at the very outset we may sweep aside a fallacy which pervades appellant's brief. Repeatedly it makes statements that the individual defendants have sold "control" of the Trust Fund, or the "fiduciary relationship", or the "agreement between the

investment company and its investment adviser" (e.g., p. 52). If a controlling block of ISI stock was transferred, the effect may have been to change *the control of ISI.*[1] But a transfer of control of ISI was not, and could not be, a transfer of control of the Trust Fund, for its automatic effect under the Act was to *terminate* the contract between ISI and the Trust Fund. *Additional* action was necessary to affect the Fund:—the affirmative vote by the investors whether to enter into a new contract with ISI.

Appellant knows this to be so; when its attention is not riveted on the artificialities of its argument, its brief admits these facts. For example:

> "* * * these agreements are not assignable by the investment adviser or principal underwriter, and, indeed, are automatically terminated upon their assignment." (Br. 18)
>
> "' The provision [Section 15] says that the management contract is personal, that it cannot be assigned * * *.' " (Br. 45)
>
> "* * * the Act is both emphatic and inclusive * * * not only that the fiduciary arrangements between an investment company and its investment adviser or principal underwriter are not assignable but also that in the event of an assignment, the fiduciary relationships themselves are automatically terminated." (Br. 66)
>
> "Existing contracts therefore cannot be assigned with or without approval of investors." (Br. 70)

3. No implied provision of the Act prohibits sale of a controlling block of stock in a service corporation or regulates the price at which it may be sold.

Lacking specific statutory support, appellant relies entirely on Section 36 of the Act (quoted, p. 6, *supra*). But that section says nothing about the sale of stock in a service corporation. It merely

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1. If any duties in the premises were owed to anyone, they were owed to the minority stockholders of ISI. The latter make no complaint, appellant makes none on their behalf, and they were given the same opportunity to sell their stock as those who sold (see p. 101, *infra*).

authorizes the Commission to sue (a) for a certain limited kind of injunction against (b) persons in certain limited classes in the event (c) they commit "gross misconduct or gross abuse of trust". And nothing in the Act confers on the Commission any power to define "gross misconduct" or "gross abuse of trust." The meaning of these terms is a judicial question, a matter of statutory construction.

Congress *explicitly* dealt with the matter of transfers of control of a service corporation by Section 15. As we shall see (pp. 49-54, *infra*), Section 36 was aimed at a different matter entirely. Appellant asserts (Br. 31) that "Section 36, far from being a postscript or statutory aside, performs a vital function in the regulatory scheme of the Act." No doubt it does, but this does not mean that the carefully drafted provisions of the Act are to be ignored and that the general terms in Section 36, "gross abuse of trust" or "gross misconduct," are to be used as a vehicle of complete regulation, overriding, changing and dominating the remainder of the Act.

Appellant seeks to conjure up a prohibition or regulation of sales of stock in a service corporation to outsiders by two types of incantation:

1. It tries to find it in "legislative history", thus founding the regulation on a supposed *real* legislative intention of Congress, albeit never expressed.

2. It tries to find it in general principles of equity jurisprudence, thus founding the regulation not on any intention of Congress but on a sort of delegation by Congress to the courts.

An examination of each approach will demonstrate the contrary of what appellant contends.

B. The Legislative History Does Not Support, but Destroys, Appellant's Contention.

For want of any help in the Act, appellant resorts to a review of its *supposed* background, makes gratuitous assertions about the

"policy" of the Act, and from this seeks to rewrite the Act into the form which the S.E.C. would now enact *if* it were Congress.

There is a proper use of legislative history in the construction of a statute. Thus "changes made in the frame of the bill during the course of its passage" aid construction, *United States v. St. Paul, M & M. Ry. Co.,* 247 U.S. 310, 318. And in the following pages we shall point to two such changes of a highly significant character. So also the formal reports of the House and Senate Committees may sometimes be referred to legitimately.

But there is an improper use of so-called legislative history, including quotations from partisan reports or from witnesses before Congressional committees, of which appellant's brief is guilty (see *Pacific Ins. Co. Ltd. v. United States,* 188 F.2d 571 (9 Cir.)).[2] When a statute emerges from Congress, it is usually the end result of pulling and hauling, and preliminary arguments and testimony are either inadmissible or of trifling value in showing what Congress intended. As said in *Ex Parte Collett,* 337 U.S. 55, at 61:

> "The short answer is that there is no need to refer to the legislative history where the statutory language is clear. 'The plain words and meaning of a statute cannot be overcome by a legislative history which, through strained processes of deduction from events of wholly ambiguous significance, may furnish dubious bases for inference in every direction.' "[3]

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2. This Court there said (p. 572):

"The new legislative history referred to is an isolated excerpt from a statement made by a witness before the congressional committee considering the legislation. As such, in our opinion, it is not entitled to consideration in determining legislative intent."

3. In *Schwegmann Bros. v. Calvert Corp.,* 341 U.S. 384, 395, Mr. Justice Jackson's concurring opinion stated:

> "Resort to legislative history is only justified where the face of the Act is inescapably ambiguous, and then I think we should not go beyond Committee reports, which presumably are well considered and carefully prepared. I cannot deny that I have sometimes offended against that rule. But to select casual statements from floor debates, not always distinguished for candor or accuracy, as a basis for making up our

1. The Investment Company Act is precise and leaves no room for enlargement by implication.

It is important to note the individual character of the Act. The courts have said that this particular Act is so detailed and precise as to leave no room for enlargement and amplification by speculation about supposed policy. In *Doyle v. Milton,* 73 F. Supp. 281, granting a motion to dismiss, Judge Rifkind said (pp. 284, 285):

> "The Investment Company Act is a carefully framed statute in which Congress has, with particularity, stated the means and methods, both judicial and administrative, by which its declaration of policy is to be executed. It has not confided in the courts a broad discretion to shape judicially contrived remedies for the mischief it has discovered. Insofar as power is entrusted to the courts under this Act its exercise must, of course, be steered toward the fulfillment of the national policy as declared. The policy itself, however, when declared in a statute as comprehensive and detailed as this Act, does not authorize the courts to fashion sanctions withheld by Congress.
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> "* * * In the case at bar, however, the court is asked to go much further: to assume that Congress has inadvertently omitted the power to disfranchise and that the court should supply the omission. All the internal evidence points inescapably to the conclusion that the omission is deliberate. Were the courts to supply it they would engage not only in judicial lawmaking where Congress is silent but in overruling the Congressional mandate.

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minds what law Congress intended to enact is to substitute ourselves for the Congress in one of its important functions. * * * It is the business of Congress to sum up its own debates in its legislation. Moreover, it is only the words of the bill that have presidential approval, where that approval is given. It is not to be supposed that, in signing a bill, the President endorses the whole Congressional Record. For us to undertake to reconstruct an enactment from legislative history is merely to involve the Court in political controversies which are quite proper in the enactment of a bill but should have no place in its interpretation."

"The motion to dismiss the second cause of action is granted."

In *Howard v. Furst,* 238 F.2d 790 (2 Cir., Nov. 13, 1956), cer. den., 353 U.S. 937, arising under the Securities Exchange Act, a companion to the Investment Company Act, the court similarly observed (p. 793):

"Ambiguous or equivocal language would hardly be sufficient to support an innovation of such far reaching effects.

* * * * * * *

"The Securities Exchange Act of 1934 is a comprehensive piece of legislation of wide scope. Significantly, where it was intended to create a right of action * * * the statute makes express provision therefor * * *."

As said in *Addison v. Holly Hill Co.,* 322 U.S. 607, 617, provisions in a statute "made in such detail preclude their enlargement by implication".

As it appears in the unannotated U. S. Code, the Act occupies 39½ large pages of fine print. The contrast with a statute of the constitutional brevity of the Sherman Antitrust Act (15 U.S.C. 1-7), for example, suffices to demonstrate that in the Investment Company Act of 1940 Congress chose to speak in detailed precision, leaving as little as possible to discretion and construction.

2. The Act was a compromise measure agreed on between the S.E.C. and the investment company industry.[4]

After the Commission had made its report (to which its brief here so copiously refers), it drafted the original bills which were introduced in the Senate as S. 3580 and in the House as H.R. 8935. Extensive hearings were held by the Senate Committee on Banking and Currency. The industry did not object to reasonable regu-

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4. So stated in Loss, "Securities Regulation", Little, Brown and Company (1951) at page 97. The author, Mr. Loss, has been Associate General Counsel of the S.E.C.

lation, but it protested that the bill went too far, was too loose, and conferred extensive powers on the Commission to formulate standards and prohibitions. The industry argued that any restrictions should be definitively outlined by Congress, and that no discretion should be given to the Commission except to *grant exemptions* from the restrictions stated by Congress.

Toward the end of the hearings, counsel for the Commission and for the industry agreed on a set of principles for a compromise bill. These were presented to the Senate Committee, which authorized counsel for the Commission and counsel for the industry to redraft the bill. As so redrafted, the bill was introduced as S. 4108 and H.R. 10065 and was enacted by Congress substantially without change.

This history was summed up in Senate Report No. 1775, 76th Congress, 3rd Session (p. 1):

> "This bill is a substitute for S. 3580 * * *.
>
> "Almost immediately after the conclusion of the hearings, representatives of the investment companies and of the Securities and Exchange Commission advised the chairman of the subcommittee that they believed it might be possible for them to reach a common ground and to submit a joint recommendation as to the scope and provisions of the bill. The chairman encouraged them in this endeavor, and as a result of their cooperative efforts, the substitute bill (S. 4108) was drafted.
>
> "The substitute bill represents the result of intensive effort for a period of some five weeks by representatives of the industry and of the Commission. Not merely the principles of this bill, but also its provisions as drafted, are strongly endorsed both by the Securities and Exchange Commission and by almost every company which appeared in opposition to the bill as originally drafted."[5]

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5. H.R. Report No. 2639, 76th Congress, 3rd Session, on H.R. 10065, gives the same history (p. 5):

> "At the hearings before the Senate Committee on Banking and Currency * * *. At the conclusion of these hearings the investment companies who had appeared submitted to the Senate committee

As a result of the industry's insistence that the prohibitions and restrictions to be imposed upon it should be precisely stated by Congress, the compromise bill consisted of 150 pages as compared to the 95 pages of the original bill. And the industry's submission that the Commission should have discretion only to grant *exemptions* from the prohibitions of Congress is exemplified in Section 6(c) and 17(b).[6]

Mr. Alfred Jaretzki, Jr., was one of the industry representatives who drafted the Act, and in an article in 26 Wash. Univ. Law Quarterly 303 (1941) he presented what is regarded as the authoritative and leading statement of the Act's legislative history.[7] He

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specific principles for the regulation of investment trusts and investment companies. Following the submission of these counterproposals for regulation by the investment companies themselves, representatives of the Securities and Exchange Commission and of the investment companies informed the Senate Committee on Banking and Currency that it might be possible for them to reconcile their differences and to recommend a bill which would be acceptable both to the Securities and Exchange Commission and to the investment-company industry.

As a result of this cooperative effort upon the part of the Securities and Exchange Commission and the representatives of the investment-company industry, this bill, H.R. 10065, and its companion bill in the Senate, S. 4108, were recommended. They represent the result of intensive effort for a period of 5 weeks by representatives of the industry and of the Commission."

6. It is notable that throughout appellant's brief when it wishes to magnify its role as guardian of the public, what it points to in this statute are the provisions authorizing it to grant such exemptions. See, for example, Br. 67, 75, 78.

7. For example, it is said in "Federal Regulation of Investment Companies Since 1940", 63 Harv. L. Rev. 1134, at 1140 (1950), that—

> "The 1940 Act was extensively discussed prior to and immediately after its enactment. Jaretzki, *The Investment Company Act of 1940,* 26 Wash. U.L.Q. 303 (1941) is probably the most authoritative treatment."

While Mr. Jaretzki is one of the counsel of record for appellees here, his article was written long before this controversy and shortly after the Act was passed.

Mr. Jaretzki's part in the drafting of the Act was stated on the floor of the House, 86 Cong. Rec. 14918; and Hearings of the Subcommittee of the Committee on Interstate and Foreign Commerce, 76th Congress, 3d Session, on H.R. 10065, at p. 63.

there summed up the matter thus (p. 311):

> "In the bill as originally introduced a very large measure of discretion was vested in the Securities and Exchange Commission to formulate standards, to impose restrictions, and to regulate conduct. Under the Act as passed there was vested great discretion in the Commission, but in the main the standards and maximum prohibitions are definitely prescribed and the discretion vested in the Commission is to grant exceptions either by rules and regulations to cover general types of situations or by order in specific cases."

And again (p. 346):

> "It would have been comparatively easy to draft a short act containing on the one hand very drastic and sweeping prohibitions and, on the other hand, setting up standards of practice in very general terms to be worked out case by case either by the Commission or the courts. * * * But the industry would have opposed this vigorously * * *. It therefore became necessary to formulate rather elaborate and perhaps complicated provisions to curtail, if not eliminate, the possibility of abuses which might arise from improper use of these relationships. * * *"

3. The answer of Congress to the problem of assignment of service contracts was to terminate the contract.

On the basis of its own reports on investment companies, rendered before any bill had been introduced in Congress[8] (App. Br.,

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8. In his 1941 article Mr. Jaretzki commented about these reports (p. 304):

> "[These reports] must nevertheless in some measure be regarded as in the nature of *ex parte* documents which have not been subjected to the test of controversy. Many statements appearing in these reports were disputed by representatives of the industry at the Senate Hearings and much of the material is subject to misinterpretation by the uninitiated. In general, it might perhaps be fair to compare the flavor of these reports to the flavor of the bill as originally introduced and the tone of the Senate and House Reports to the tone of the bill as finally enacted." (Italics in original.)

pp. 28 et seq.), appellant argues that there was a problem in connection with the transfer of service contracts. This is true. But the problem was that transfers could result in the investors having nothing to say about the identity of the underwriter or adviser. *This* was the problem. As appellant's brief notes (p. 36), prior to the Act investors could have control over "their funds transferred to successors they did not choose or even know". And Congress met this problem by prescribing that a service contract was not assignable at all, and that any attempt to assign it automatically terminated it, as did transfer of control of the service corporation (see p. 28, *supra*). In short, its remedy was to require a new contract to be placed before the investors for adoption or rejection.[9]

This was Congress' answer, given after hearing the S.E.C.'s report, listening to the representatives of the industry, and then accepting the compromise bill which the S.E.C. and the industry worked out. It did not adopt any regulation other than that contained in Section 15 itself.

4. The change in Section 1(b) and the formal reports of the Senate and House Committees.

A reading of the references made by appellant to its own prelegislation reports will disclose that they lend its theory no support. And if we turn to legitimate legislative history, we find that *it* discloses that Congress intended to provide no remedy other than the one it explicitly stated. Section 1(b)(6) of the Act declares that the "national public interest and the interest of investors" which the Act is designed to protect are adversely affected

> "when investment companies are reorganized, become inactive, or change the character of their business, *or when*

9. To the same end of preventing control or management of investment companies from being free of the control of the security holders, Section 16 restricts the proportion of directors who may be elected without their vote.

the control or management thereof is transferred, without the consent of their security holders;"

In the original bill introduced in the Senate by Senator Wagner on March 14, 1940 (S. 3580, 76th Congress, 3d Session) the comparable provision, Section 2(6), read as follows:

> "when investment companies are reorganized, dissolved, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders **and without adequate public supervision;"**.

The only change in the section as passed (besides the numbering and omission of "dissolved") is the deletion of the words **"and without adequate public supervision"**, a clear proof that Congress deliberately decided that the only requirement it wished to impose in case of transfer of a service contract was that the investors have the right to determine for themselves whether the contract should continue. It intended no other public regulation or supervision.

It is interesting to note that in appellant's extensive quotation (pp. 32-34) from the "SEC Report on Investment Trusts and Investment Companies", it omits the following sentence which immediately preceded what it does quote:

> "Throughout these entire processes of acquisition and reorganization and their attendant readjustment of shareholders' rights, no independent body existed with authority to supervise, regulate, or pass upon the fairness of changes in control, exchange offers, mergers, consolidations, and sales of the entire assets of investment companies." (p. 1029).

Section 2(6) of the original bill, drafted by the Commission itself, is in line with this passage. It may be that at one time the Commission would have liked to have a statute which gave it supervision of changes in control. But Congress granted no such authority. Congress agreed with the philosophy that knowledge by the investors and their consent were enough.

The following passage also appeared in the S.E.C. Report, after the first full paragraph quoted on page 33 of appellant's brief:

> "Nevertheless, when these contracts became unprofitable or when the revenues accruing to the managers from them had substantially declined, these contracts were assigned to new interests without the *prior knowledge or consent* of the stockholders."

This sentence emphasizes the element of knowledge and consent of the stockholders.

It is noteworthy that neither of these passages appears in appellant's brief, although both were quoted in its brief in the District Court.

It is further to be noted that neither the report of the Senate Committee on Banking and Currency on S. 4108 (Report No. 1775) nor the report of the House Committee on Interstate and Foreign Commerce on H.R. 10065 (Report No. 2639) comments on any problem in connection with assignment of contracts except the lack of prior knowledge or consent of investors. Thus Senate Report No. 1775 stated (p. 7):

> "Similarly, after investors have invested in companies on their faith in the reputation and standing of the existing managements, control of the public's funds has frequently been transferred without the prior knowledge or consent of stockholders to other persons who were subsequently guilty of gross mismanagement of the companies."

This is the whole of the comment. The same is true of House Report 2639, where it was said (p. 9):

> "Similarly after investors have invested in investment companies on their faith in the reputation and standing of the existing managements, control of the public's funds has frequently been transferred without the prior knowledge or consent of stockholders to other persons who have looted the assets of such companies or to other investment companies which have subjected the stockholders to grossly unfair plans of merger, consolidation, or other corporate readjustments."

Nowhere in these official and formal Congressional reports is there a breath of suggestion that sale of stock in service corporations was to be regulated or the price limited.

5. When Congress meant to provide a specific regulation or a specific prohibition in the Act, it did so explicitly.

We have said that when Congress meant to provide a specific regulation in this particular Act, it demonstrated that it knew how to do so explicitly. Appellant's brief confirms that statement by noting many instances of detailed regulations (e.g., pp. 37, 38). For example, it points to Section 25 in support of an argument (Br. 74, et seq.) that it is not enough that the investors have the power to decide for themselves whether to reinstate a service contract after termination by assignment, and that the Commission is the guardian of the investors empowered to seek an injunction against the service corporation's acting under the new contract approved by the investors. Section 25 relates to reorganizations, and appellant argues that although reorganization plans are often voted on by the stockholders,

> "Nevertheless, whether or not the plan is approved by the security holders, the Commission, under Section 25 (c), may obtain an injunction against the consummation of the plan if the court determines the plan to be 'grossly unfair or to constitute gross misconduct or gross abuse of trust on the part of the officers, directors, or investment advisers of such registered company or other sponsors of such plan.' " (Br. 75)

But this argument unhorses appellant. The original bill drafted by the Commission provided that all plans of reorganization of investment companies had to be approved by the Securities and Exchange Commission. Upon objection by representatives of the industry, Section 25 was revised to its present form, and the Commission was not authorized even to comment upon plans of reorganization, except upon request by 25% of outstanding security holders, and was only given authority to institute proceedings in an appropriate District Court of the United States to enjoin a re-

organization in the circumstances mentioned by appellant. Even this limited authority is given *explicitly* and is not left to implication. This is quite reminiscent of the action of Congress in respect of Section 1(b) (6), in striking out the recitation that it was against the national public interest and the interest of investors when the control or management of investment companies was transferred *"without adequate public supervision"*. As respects assignment of a service contract Congress was content to say that the contract comes to an end, and that it is up to the investors to decide for themselves whether to recreate it.[10]

C. The essence of appellant's arguments is that it is not satisfied with the answer of Congress.

The gist of the present case is that appellant is not satisfied with the answer Congress gave. It lacks the faith that Congress had in the investor and is not content, as Congress was, to leave to him the question of reinstatement of a contract in any event that terminated it. Thus appellant states (Br. 70):

> "There is no basis for assuming that the Congress intended Section 15 to preempt this vital and sensitive area of regulation to the exclusion of Section 36."[11]

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10. Appellant makes another self-defeating argument of the same nature, at page 75. It states:

> "Similarly, certain transactions between a registered company and its affiliate are prohibited under Section 17 (a) unless an *exemption* is obtained under Section 17 (b). The grant of the exemption is conditioned on a finding by the Commission, *inter alia,* that the proposed transaction is fair and 'consistent with the general purposes' of the Act. The Commission rejected a construction which 'would, in effect, make a vote of security holders a substitute for review under Section 17 (b).' "

Note that the prohibition is explicitly stated by Congress, and that the Commission was given no power but to grant an exemption (see p. 36, *supra*).

11. In its brief below appellant had said (p. 27):

> "We do not doubt, of course, the importance of investor self-help and provisions to that effect, in appropriate cases, are contained in Sections 15 and 16 of the Act."

It omits this gracious admission from its brief on appeal.

This comment puts the matter backwards. The question is whether there is any basis for assuming that Congress intended something which it did not express. Unexpressed intentions are not legislation. As the Supreme Court said in *Addison v. Holly Hill Co.,* 322 U.S. 607, 617, "after all Congress expresses its meaning by words." The correct question is whether there is any basis in the statute for assuming that Congress intended Section 36 to operate on the problem explicitly dealt with in Section 15.

Appellant argues (Br. 75, 76):

> "That the Congress did not declare in *haec verba* the sale of the succession to the office of investment adviser or principal underwriter to constitute a breach of trust, is not significant." [12] (Italics in original.)

On the contrary, Congress showed, in the many detailed pages of the Act, an ability to state exactly what it wished to provide. If a further remedy was so obvious, Congress could have provided it. It did not do so. As said in *62 Cases of Jam v. United States,* 340 U.S. 593, 600,

> "In our anxiety to effectuate the congressional purpose of protecting the public, we must take care not to extend the scope of the statute beyond the point where Congress indicated it would stop."

In *Wilder Mfg. Co. v. Corn Products Co.,* 236 U.S. 165 at 174, the court refers to—

> "the familiar doctrine that 'where a statute * * * gives a new right and declares the remedy, * * * the remedy can be only that which the statute prescribes.' "

In *62 Cases of Jam v. United States, supra,* the Court rejected the Federal Security Administrator's construction of the Federal Food, Drug and Cosmetics Act. One section dealt with imitation foods, another empowered the Administrator to fix "standards of iden-

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12. This, of course, assumes that there is an "office" or that there can be a sale of the succession to the service contract. These are false assumptions. (See pp. 29, 30, *supra*).

tity". Relying on the latter the Administrator determined that no product could be marketed as "imitation jam". Said the Court, pp. 599-600:

> "It looks and tastes like jam; it is unequivocally labeled 'imitation jam.' The Government does not argue that its label in any way falls short of the requirements of § 403(c). Its distribution in interstate commerce would therefore clearly seem to be authorized by that section. We could hold it to be 'misbranded' *only if we held that a practice Congress authorized by § 403(c) Congress impliedly prohibited by § 403(g).*"

So here: In Sections 15 and 2(a)(4), Congress explicitly dealt with the sale of a controlling block of stock in a service corporation, and it recognized that the contract could be reinstated by vote of the investors. A practice recognized by these sections was not prohibited by the general words of Section 36.

In *Colgate Co. v. Labor Board,* 338 U.S. 355, 363, the Court expressed the same thought:

> "The Board cannot ignore the plain provisions of a valid contract made in accordance with the letter and the spirit of the statute and reform it to conform to the Board's idea of correct policy. To sustain the Board's contention would be to permit the Board under the guise of administration to put limitations in the statute not placed there by Congress."

A statute cannot be expanded by belittling the remedy Congress has provided.

Appellant discredits and belittles the machinery provided by Congress as the investor's protection. Thus it states (Br. 80):

> "The intimation by the court below (R. 149) that, given the right to elect their investment adviser and principal underwriter, investors would overcome their inertia and mobilize in protest against those who pay for the succession to these contracts, seems to us implausible and unrealistic. If the court below is sustained in its view that such transactions are proper and valid, it is not likely that the investors would undertake to oppose an entrenched management which legally or *de facto* is committed to further the

> interests of the successful bidder. Indeed, with the legality of these transactions no longer subject to question, the investors' trust and confidence in the old management, established over the years, will prove a weighty, and probably the controlling factor, in favor of its nominee or successor." (Italics in original.)

And again (Br. 55):

> "Although under Section 15 these contracts are terminated, no effective opposition to any new contracts with the successors, as we shall see (pp. 80-81, *infra*), is likely to develop among public investors; nor, significantly, within the fund management, some of whose influential or controlling members, as in this case, are likely to be parties to the sale." (Italics in original).

This means no more than that the *S.E.C. has no faith in the machinery* which Congress thought sufficient—no faith in the ability of investors to care for themselves. It wishes to be their guardian. **But Congress did not so provide.**

The Supreme Court has spoken about similar efforts to expand a statute by belittling Congress' handiwork. In *Bruce's Juices v. American Can Co.*, 330 U.S. 743 it said (p. 752):

> "To indicate its need that the Court establish this additional remedy unauthorized by Congress, it [appellant] seeks to discredit and belittle both of the remedies Congress has expressly authorized."

And (p. 750):

> "The Act prescribes sanctions, and it does not make uncollectibility of the purchase price one of them. * * * This triple damage provision to redress private injury and the criminal proceedings to vindicate the public interest are the only sanctions provided by Congress.
>
> "It is contended that we should act judicially to add a sanction not provided by Congress by declaring the purchase price of goods uncollectible where the vendor has violated the Act. It may be admitted as argued that such a sanction would be an effective enforcement provision. Addressed to Congress, this argument might be persuasive, but the very fact that it

> would obviously be an effective sanction makes it even more significant that the Act made no provision for it; that no committee dealing with the Robinson-Patman Act proposed it; that not one word suggesting its consideration appears in the debates of Congress; no proponent of the Act pointed out in its favor that it would be self-enforcing because of this sanction; and no opponent pointed with alarm to the consequences of such a drastic sanction on the commerce of the nation."

In the case just quoted the Court noted that no further remedy had been discussed in Congress. *Here more had been discussed but was rejected* (see p. 39, *supra*).

In *Switchmen's Union v. Board,* 320 U.S. 297, 301, the Supreme Court acutely observed of a contention that a certain remedy or procedure was necessary:

> "Congress for reasons of its own decided upon the method for the protection of the 'right' which it created. It selected the precise machinery and fashioned the tool which it deemed suited to that end. * * * All constitutional questions aside, it is for Congress to determine how the rights which it creates shall be enforced. *Tutun v. United States,* 270 U.S. 568, 576-577. In such a case the specification of one remedy normally excludes another. [Citations omitted]"

In the leading discussion of the Act (Jaretzki, 26 Wash. Univ. L. Q. 303 (1941), it was said (p. 346):

> "It was not intended that the Act should be a complete cure of all possible evils in the investment company field. It seemed wiser to proceed cautiously and experimentally, attempting to prevent the main abuses which had been known to exist."

And as said in *Addison v. Holly Hill Co.,* 322 U.S. 607, 617:

> "Legislation introducing a new system is at best empirical, and not infrequently administration reveals gaps or inadequacies of one sort or another that may call for amendatory legislation. But it is no warrant for extending a statute that

> experience may disclose that it should have been made more comprehensive."

There is in fact no gap in the law. But if the appellant feels otherwise, it should address itself to Congress, not to the courts. To adopt an observation made in *Lauritzen v. Larsen,* 345 U.S. 571, 593:

> "The argument is misaddressed. It would be within the proprieties if addressed to Congress."

D. There has been no "gross abuse of trust" or "gross misconduct". No principle of equity supports appellant.

Failing to conjure up from legislative history a regulation of the price at which stockholders in a service corporation may sell their stock, appellant seeks to insinuate it into Section 36 through the words "gross abuse of trust" and "gross misconduct". It asks the court to create a *new* rule of equity jurisprudence:—to announce it to be a fiduciary obligation owed investment companies by certain stockholders in service corporations not to sell a controlling block of their stock for more than physical asset value. No decided case, no principle of equity governing the conduct of fiduciaries, no understanding of business relationships and realities and of the simple principles of contract law, support this effort.

Appellant smoothly speaks of "self-dealing" (e.g., Br. 33, 37), of transactions between the investment company and their service corporations, of "faithless fiduciary" (Br. 18), and of "financial frauds" (Br. 30), **although, admittedly, none of these elements is present.** And it makes an extensive use of other emotive adjectives, like "trafficking" and "trading" in investment advisory and principal underwriting contracts (Br. 31, 83).[13] Characterizations like these answer no legal problem.

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13. These words appear nowhere in the Act, or in the Senate or House Committee Reports or, so far as we can ascertain, in the Commission's voluminous reports.

Since a sale of controlling stock in a service corporation terminates the contract, there can be no "trafficking" (see pp. 29, 30, *supra*).

We call attention, again, to the concessions which the facts compel appellant to make (see p. 11, *supra*) and which may be summarized thus:

The transactions in question—the sale of stock in ISI by its stockholders—were transactions with outsiders and not with the Trust Fund. Here is no case of those in control dealing with their beneficiaries. No defendant bought anything from, or sold anything to, the investment company. There was no diversion, use, waste, or appopriation of assets of the Trust Fund and no mismanagement of the Fund; and appellant is "not suggesting that the new controlling interests in ISI will abuse their fiduciary position with respect to the Trust Fund" (App. Br. 80).

1. To whom the parties were fiduciary and in what respects: The right and left sides of the Chart.

There is much emphasis by appellant that ISI was a "fiduciary" to the Trust Fund. But this does not even begin to answer *any* question in the case. As said in *Securities and Commission v. Chenery Corp.*, 318 U.S. 80, 85:

> "We reject a lax view of fiduciary obligations and insist upon their scrupulous observance. * * * But to say that a man is fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"

ISI did bear a fiduciary relationship to the Trust Fund, created by a contract authorized by the Act. In the performance of *its* duties to the Fund unquestionably ISI had to observe fiduciary standards. But this did not draw its whole existence into the fiduciary orbit. And it did not make the stockholders in ISI fiduciaries to the Fund with respect to their stock in ISI.

We refer again to the chart on page 5, *supra*. That chart may be divided into two sides, a left and a right—the ISI side

and the Trust Fund side. Relationships between one side and the other are fiduciary; relationships, inter se, between elements wholly on one side may be fiduciary. But transactions between someone on one side, in respect of his property, *with an outsider,* are not fiduciary to the other side at all.

If ISI had sought to sell securities *to* the Trust Fund, or to buy securities *from* the Trust Fund, then it would have been acting in the realm of its fiduciary relationships. But the Act does not leave this to implication. It explicitly prohibits purchases from and sales to an investment company by its investment advisers and by directors of an investment adviser (Act, Sections 17 (a) (1) and (2)).

If ISI had sold its typewriters, its tables, or its sales organization to third parties, it could have done so at any price because it would have been acting outside of its fiduciary relationship. And similarly, when *its* stockholders sold *their* stock, they were acting outside of any fiduciary relationship borne to the Trust Fund by reason of ISI.

2. Section 36 relates to self-dealing,—to transactions between the service corporation and the investment company: This is shown by its legislative history.

In the testimony before the House Committee on the compromise bill which became the Act, Commissioner Healey of the S.E.C. said:[14]

> "The representatives of the investment-trust industry were of the unanimous opinion *that self-dealing—that is, transactions between officers, directors, and similar persons on the one side, and investment companies with which they were associated on the other*—presented an opportunity for *gross abuse* by unscrupulous persons through unloading of securities upon the companies; through unfair purchases from the companies; and from obtaining of unsecured or inadequately secured loans from those companies. The industry seems to

14. Hearings of the Sub-committee of the Committee on Interstate and Foreign Commerce, 76th Congress, 3d Session, on H.R. 10065, p. 59.

recognize that even for the most conscientious management, *transactions between these affiliated persons and the investment companies present many difficulties.* Many investment companies have voluntarily barred this type of transaction—but not all of them.

"The small investors in certain investment companies, particularly in unit investment trusts and open-end management companies, have been subjected to so-called switching operations from one investment company to another, often controlled by those who controlled the first company, to the disadvantage of the investors. Similarly investors have been often powerless to protect themselves against plans of reorganization which have been grossly unfair or which have constituted gross abuses of trust on the part of their sponsors."

The Report of the Senate Committee on the bill (Report No. 1775) contained the following (p. 6):

"Basically the problems flow from the very nature of the *assets of investment companies.* The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies. *These assets* can and have been easily *misappropriated and diverted* by such types of managements, and *have been employed to foster their personal interests* rather than the interests of public security holders."

And (at p. 7):

"The representatives of the investment trust industry were of the unanimous opinion that '*self-dealing*'—that is, transactions between officers, directors, and similar persons and the investment companies with which they are associated—presented opportunities for gross abuse by unscrupulous persons, through *unloading of securities upon the companies,* unfair *purchases from the companies,* the obtaining of unsecured or inadequately secured loans *from the companies,* etc. The industry recognized that, even for the most con-

scientious managements, *transactions between these affiliated persons and the investment companies* present many difficulties. Many investment companies have voluntarily barred this type of transaction."

Almost identical statements appeared in House Report No. 2639:

"That investors in investment trusts and investment companies are subject to substantial losses at the hands of unscrupulous persons is obvious from the very nature of the assets of such companies. Their assets consist almost invariably of cash and marketable securities. They are liquid, mobile, and easily negotiable. *These assets* can be easily *misappropriated, 'looted,'* or *otherwise misused* for the selfish purposes of those in control of these enterprises." (pp. 7, 8).

* * * * * * *

"Second,[15] unscrupulous individuals in control of investment companies have not hesitated to engage *in self-dealing; that is, transactions between officers, directors, and similar persons and the investment companies with which they are associated.* These individuals *have sold worthless securities* at extravagant prices *to their controlled companies, have purchased securities* and other property *from such companies* at unfairly low prices, and *have borrowed extensively and* without repayment from such companies. The industry recognized that even for the most conscientious managements, transactions between these affiliated persons and the investment companies present many difficulties. Many investment companies have voluntarily barred this type of transaction." (p. 9)

It is clear that *gross abuse* relates to transactions between those guilty of it, on the one side, and the investment company on the other. There was no such transaction here.

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15. This passage immediately followed that quoted at page 40, supra.

3. The fact is also shown by the only decision involving Section 36.

Appellant's only citation involving Section 36 is *Aldred Investment Trust v. S.E.C.,* 151 F.2d 254.[16] There the investment company was a Massachusetts common-law trust, registered with the S.E.C. as an investment company. The individuals of whom the S.E.C. complained purchased shares *in the trust fund.* (By contrast in this case, the individuals owned stock in the Service Corporation.) By virtue of their ownership of these shares, they selected themselves and their nominees as trustees, not of the service corporation, but *of the trust fund itself.* Then, as trustees of the fund itself, they used the trust's assets to buy horse race tracks so as to elect themselves directors and officers of the race tracks in order to draw fat salaries. It will be observed (1) that the persons committing the misconduct were trustees and officers of the investment company itself, and (2) that their misconduct consisted of using the assets of the trust fund to their own gain. This is what Section 36 means by "gross abuse of trust" or "gross misconduct". In the brief filed by the Commission in the Court of Appeals in the *Aldred* case, the Commission said, "In substance, the judgment was that Hanlon and his associates could not be trusted with the management of other peoples' money." (pp. 43)

Appellant cites the *Aldred* case as adopting the approach of interpreting Section 36 to effectuate the "policy and purpose of the Act." We therefore quote what the S.E.C. itself said in its brief in the Court of Appeals in that case, filed in 1945 (p. 11):

> "Section 36 deals only with a 'gross abuse' of trust and *is intended to cover such substantial deviation* from the obligations of trusteeship *as would indicate that the officers and directors involved cannot be entrusted with the management of other people's money* without substantial danger that the trust will be turned to the benefit of the manager rather than to the benefit of all classes of security holders."

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16. *Bailey v. Proctor,* 166 F.2d 392 (1 Cir.), also cited by appellant, was an aftermath of the *Aldred* case.

Yet it has been conceded in the present case that no such conduct involving mismanagement of other people's money has occurred. (See p. 48, *supra.*)

The S.E.C.'s *Aldred* brief went on to record the view *that the standards of Section 36 are tied in to the statements in Section 1 of the Act.*[17] *But none of those statements has any relation to the kind of conduct involved in the present suit.* Essentially, the prohibited conduct relates to transactions done *on behalf of the trust* but which have as their purpose the serving of individual interests of the management as opposed to the interests of the investors.

4. It is only a GROSS abuse of trust or GROSS misconduct to which Section 36 applies.

The inapplicability of Section 36 is borne out by the fact that it does not speak of "abuse of trust" or "misconduct" but of "*gross* abuse of trust" and "*gross* misconduct". All terms of the Act must be given effect. The word "gross" must not be ignored.

Before Congress passed the Act courts gave relief at the suit of injured persons for acts of misconduct and abuse of trust. Congress did not entrust to the S.E.C. the vindication of all acts of misconduct or abuse of trust in the corporate field. It entrusted

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17. Thus the S.E.C.'s *Aldred* brief said (p. 11):
"The statutory declaration of purposes in the Act is a codification of the fiduciary obligations imposed upon directors and officers of investment trusts; and this standard as well as the substantially identical common law standard is to be considered in determining whether there has been such substantial deviation from that standard as to constitute a gross abuse of trust. The standard, as Judge Sweeney noted, is set forth in Section 1 of the Act. Thus Section 1(b) states in part as follows:"

Here followed quotations from Section 1(b) and subdivisions 1, 2, 3, 5, 6 and 8.

Subdivision 1 refers to conduct by investors with respect to purchase or sale of securities *between them and the investment adviser*. Subdivision 2 relates to operation of the investment company or its portfolio for the interests of the fiduciary. Appellant has disavowed that it claims any such conduct here. There is no claim of violation of Subdivisions 3, 4, 5 and 8, and, of course, Subdivision 6 sets a policy which was carried out *by the precise language of the Act in Section 15 and adhered to by defendants.*

to the S.E.C. the duty and authority to take action with respect to misconduct or abuse of trust that was gross. And in order to be gross, the conduct had to be an abuse by sturdy and well-settled standards and not merely by novel or rarified views. As said by Judge Rifkind, *Securities and Exchange Commission v. Okin,* 48 F. Supp. 928, 931, in reference to provisions of the Act, they

> "are intended to govern ordinary mortals, not saints. They should not be so construed as to impose canons of conduct too lofty for human acceptance."

We submit that where defendants have *not* "mismanaged or misappropriated any of the assets of the Trust Fund", there can be no case of *gross* abuse of trust.[18]

5. The sale by a stockholder in a service corporation of his stock, regardless of amount of stock or price, is not an abuse of trust "in respect of" the investment company because it does not use any asset of the investment company and is not a dealing with it.

The stockholders of the Service Corporation did not deal *with assets of the investment company but with their own shares in the Service Corporation.* They did not deal with the Trust Fund or the investors but with strangers.

ISI, on the one hand, and the Trust Fund through its investors, on the other, entered into a contract whereby the latter agreed to

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18. We do not find in appellant's brief any attempt to account for the adjective "gross". In its brief in the District Court, it argued that "gross" was used to distinguish wilful acts from mere negligence. The distinction between negligence, which is an unintentional act, and wilful conduct, which is conduct deliberately done, is so elementary in the law (Cal. Civil Code, §1714; *Donnelly v. Southern Pacific Co.,* 18 Cal. 2d 863, 869; 118 P.2d 465, 468) that if this is the distinction Congress had in mind, it would have used the customary apt words for the purpose, instead of adopting phraseology which in ordinary parlance connotes something entirely different. The progression of culpability is (1) negligence, (2) wilful conduct, and (3) maliciously wilful conduct (Bouvier's Law Dictionary, Tit. "Wilfully"). "Gross" distinguishes the third from the second, not the second from the first. The adjective "gross" and the term "gross misconduct" connote conduct reprehensible in the extreme, something abandoned and debased. Cf. *Stanley v. Jones,* 9 So. 2d 678, 201 La. 549, where a judge accepted "kickbacks", made false statements under oath, wrote threatening letters to procure votes, etc.

pay to the former fees for services rendered. Appellant apparently believes that the only reason that a purchaser of stock in a service corporation would pay more than the bare physical asset value is that he is buying the right to control the performance of the services and thus to earn fees. This, it is assumed, is an "asset of the trust". That assumption defies simple clear thinking. Yet the whole superstructure of appellant's reasoning rests upon it.

When a controlling block of stock in a service corporation is transferred, *the service contract terminates*. The Act so provides. *The purchaser of the stock thus buys no contract nor the control of one*. The investors in the trust fund at once are free to enter into a new contract with the service corporation under new control, or to refuse to do so. Doubtless the purchaser of the stock hopes that the service corporation, having done a good job in the past, can persuade the investors that it will continue to do so in the future, so as to warrant renewal of the contract and the continued earning of service fees.[19] It may be that this hope is one of the factors which leads him to pay more than the bare asset value for the stock.[20] But even were it the sole factor, it would be irrelevant.

It is appellant's theory that any value attached to the hope or expectation that ISI will obtain a new service contract with the

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19. The buyer, however, has no assurance and he takes his chances. Illustrative of this is the fact that the last sale, whereby the defendant Leach contracted in July 1956 to sell 16,000 shares of stock, expressly provided that it would be consummated whether or not the investors in the Trust Fund reinstated the investment contract or rejected it (see p. 8, *supra*).

20. Patently there are many other factors. The notion that the value of the stock of a service corporation is fixed by its asset value is naive. For example, it attaches no value to good will, which experience shows may be very great. It takes many years to build up a trained staff to supervise and manage proficiently the securities of investment companies, to build a statistical and administrative organization, and to build a selling organization to sell the securities of such a company. Large capital sums may have been expended in building up the organization; yet these expenditures are not reflected in the asset value. Organizations such as these cannot be duplicated easily. Moreover, they contain the possibility of building up a much larger business and of expanding to other fields.

Trust Fund belongs to the Fund. Thus the complaint contains the following wholly conclusory allegation which serves to show appellant's theory (R. 9; para. 20):

> "The price of $50 per share paid, and agreed to be paid, to the sellers does not represent the real and actual value of the Insurance Securities shares. The payment of 25 times the net asset value represented no payment for any asset or assets owned by Insurance Securities. Ostensibly and necessarily, the purchase price reflected the value of the perquisites and emoluments[21] which Insurance Securities derives from the substantial fees paid, and to be paid, by the Trust Fund to Insurance Securities under the Investment Advisory and Principal Underwriting contracts, which under the Trust Agreement and under the Act, as noted in paragraph 11, supra, are not assignable. The value attached to said contracts are an asset of the Trust Fund, and in law and equity is preserved for the benefit of such Trust Fund."

And similar assertions are made in appellant's brief (e.g., pp. 19, 45). But the statement that "The value attached to said contracts are [sic] an asset of the Trust Fund" is simply fanciful.

Every contract has *a separate value to each party to the contract.* If it were of value to only one party, no contract would be made. Here the two parties were the Service Corporation, on the one side, and the Trust Fund, on the other. The value to the Trust Fund is that it obtained investment, administrative, and sales service. The value to the other side, ISI, lies in the fees received. To hand *that* value to the Trust Fund is to destroy the essence of contracts, which is that the contract must have a value to each side. If there is an expectation that the contract, when ter-

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21. This is rhetoric. There are no perquisites and emoluments. There are merely fees for services rendered, fixed by contract, which, if not obtained from one service company, would have to be bought from another.

Appellant spends space arguing that the issue of the value of the stock cannot be determined on affidavits (Br. 46). We did not touch on that subject anywhere in our affidavits. We proceed on the basis of the factual allegations of the complaint though not its conclusions.

minated by any act specified by law, may be renewed and fees continued, and if that expectation has a value, it is a value that pertains to the ISI side of the contract, not to the Trust Fund side.

This truth is apparent from a further consideration: Suppose the stock in ISI were sold by the shareholders at a lesser price than $50.00 per share. The same fees would continue to be paid by the Trust Fund or by the investors. Or suppose the stock were not sold at all. The same fees would continue to be paid. Or suppose that, after the sale, the Service Contract was not reinstated but was given to someone else. The same fees would continue to be paid by the Trust Fund in the future. In short, none of these contingencies has any bearing. *The sale of the stock in ISI takes away from the Trust Fund and its investors not one penny that otherwise would be kept nor adds one penny to its expense.*

6. The sale of stock in corporate fiduciaries is commonplace.

American law and economic life are replete with *corporate* fiduciaries who perform their service for an agreed fee. No one can deny that a corporate fiduciary is entitled to make a profit from its services. To deny this would constitute failure to recognize that there are "strict trusteeships" and there are "quasi-trusteeships in which self-interest and representative interests are combined."[22] The present case involves the latter. The fiduciary must perform his fiduciary duties with fidelity, but he is not to be denied his compensation.

The stock of corporate fiduciaries is freely bought and sold, and the value of the stock, like the value of stock in many corporations, is fixed in relation to expected earning power of the corporation. Yet no one has ever contended that this constitutes

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22. The phraseology comes from *Mosser v. Darrow,* 341 U.S. 267, 271.

a breach of trust, or that the price must be scaled down, or paid to the beneficiaries, or that the service fees must be reduced!

In San Francisco and Oakland as well as elsewhere there are numerous banks with trust departments. The expectation of earning fees from future performance of trust services is an element entering into a calculation of the value of the bank's stock. Would anyone contend that when a bank is sold to purchasers, the portion of the consideration attributable to this factor belongs in equity to the beneficiaries for whom the trust department acts? Obviously not.

Another example of a fiduciary relationship is that of life insurance companies to the insured. Yet stock in stock insurance companies is sold at prices which include as an element of value some multiple of "imputed earnings" based on "business in force." This is nothing more than an expectation that insurance written will not lapse and that premiums will continue to be paid in the future.[23]

On appellant's reasoning, stockholders in trust companies or life insurance companies, if directors, would not be permitted to realize the value of their stock but would have to use their position to bring about a reduction in rates and premiums.

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23. See "Investors Analyses of the Financial Position and Operating Records of Twenty-five Life Insurance Companies", published by John C. Legg & Company; p. 1 of the 1956 issue contains the following:

> "*Value of Business in Force:* * * * There is, however, a decided value to the business in force. This value depends upon the mortality experience, lapse ratio, interest assumption and methods used in setting up reserves, and does, therefore, vary considerably between companies.
>
> "The average value of the non-participating ordinary business of a life insurance company which enjoys a favorable mortality experience, a moderate lapse ratio and reserves on a sound valuation method, may be stated at $15 per thousand. The average value of the participating ordinary may be stated at $2.50 per thousand and the average value of the industrial business may be stated to be 26 times the weekly debit."

7. Appellant's contention rests on the claim of a "conflict of interest", and that claim is based on arguments that are speculative, naive, and assume powers not granted appellant by Congress.

Appellant's brief is replete with general propositions of equity.[24] But first we must see in what respect appellant contends that the sale of stock by stockholders *of ISI* could constitute a disregard of fiduciary obligations *to the Trust Fund.* It lies, appellant tells us, in the fact of "actual and potential conflicts of interests" (Br. 30, 36) and in the "public policy * * * to prevent corrosion of the fiduciary responsibilities of those who have undertaken to manage money or property of others or to act on their behalf" (Br. 66).

But we must press the inquiry to see precisely wherein appellant believes the "conflict" lies or the "corrosion" is possible.

(a) Essentially appellant is seeking to set itself up as a rate regulating agency empowered to limit the fees a service corporation may earn.

Appellant states (Br. 80):

> "No thought is likely to be given by those in control to use the occasion of the sale for improving the position of investors through more advantageous investment advisory or underwriting contracts with the successors, although under Section 15 the selection of the new adviser or underwriter is within the power and authority of the public investors."

Thus appellant's case is bottomed *on the assumption that ISI and its stockholder-directors are under a fiduciary duty to renegotiate the service contract with the Trust Fund to reduce the fees to the lowest possible figure.*

During the oral argument the District Court pressed appellant's counsel to state just what it was that made a sale of stock in ISI wrongful. And counsel replied, "It is the price", the fact of a profit.[25]

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24. Thus *Union Pacific Railway Co. v. Chicago etc. Ry.,* 163 U.S. 564, 601 (Br. 67, 84) merely states that equity is flexible and may devise new remedies; it pertains to procedure and not to substantive rights.

25. "The Court: No, now what is the thing, at what point are we to come in and upon what standard do we base the decision to do something,

With this the fallacy in appellant's cause stands exposed. The essence of its theory is that stockholders of a service corporation, if they are also directors of that company, may not sell their stock at a profit or at more than physical assets value. But if sale of stock at a profit means a "profiting from their fiduciary relationship to the Trust Fund", as appellant claims (Br. 12), so does the receipt of more than nominal dividends on ISI stock, for they also represent the profit earned by ISI from the service contract. To say that a director-stockholder may draw dividends so long as he holds the stock, but when he sells or dies, he or his estate cannot sell the stock at a price giving any recognition to the company's earning power,—to say that he can enjoy the value of his interest in the corporation only by remaining a stockholder, deprives his stock of one of the basic ingredients inherent in the nature of corporate stock, the right to sell.

In short, appellant's theory denies a service corporation the right to make a profit from the performance of services. If directors owning a controlling stock interest in a service company are under a fiduciary duty to renegotiate the service fees downward when they wish to sell their stock, like reasoning would impose that duty at all other times.

And if they are under this duty, how low must the fees go before equity is satisfied? To make any sense out of appellant's

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putting it colloquially, personally against the men who have made the transfers?

* * * * * * *

"Mr. Levy: It is the price.

* * * * * * *

"The Court: Well, what you are really saying there is that you don't like this transaction, that it is just too much. They got too much money out of this thing, and it should be redistributed in some way.

* * * * * * *

"The Court: But if they sold it at no profit?

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"Mr. Levy: If they sold it at no profit, then it is simply—there is nothing wrong, for example, for a director or for a trustee who happens to occupy a position of office—" (Transcript of hearing 87, 88, 89).

reasoning, it must mean that a service corporation may charge fees only sufficient to give it a "reasonable" return on its investment in the necessary physical assets and, possibly, to pay "reasonable" salaries. By this reasoning, *the S.E.C. sets itself up as a sort of Interstate Commerce Commission, a rate-fixing agency, or it assumes the power* to ask the Court to take on that role.

But Congress has conferred no such general power on Commission or Court. It has left fees to be determined primarily by contract between investor and service company, providing in Section 15(a) (1) that the contract must "precisely describe[s] all compensation to be paid thereunder." It has not seen fit to go further, except in limited circumstances, which demonstrate that when Congress wanted to state powers or impose restrictions it knew how to do so explicitly.[26] *No power was conferred to regulate fees indirectly by attacking the price at which stock can be sold.*

The right to make money out of a contract in the amounts contracted for cannot be questioned. The Act recognizes it. It follows that the expectation of renewal of profitable contracts has a capitalized value which is an asset of the company which in turn is properly an element in valuing its stock.

(b) Contentions that there is a danger that hazardous or doubtful policies will be pursued are imaginative in the extreme.

In developing its concept of "conflict of interest", appellant becomes disingenuous. Thus it suggests (Br. 22, 80):

> "* * * the purchasers may be tempted to pursue hazardous or doubtful policies in order to recoup as quickly as possible the substantial price they paid for stock control * * *."

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26. In the case of periodic payment plan certificates, Section 27(a)(1) fixes the maximum "sales load", Section 27(a)(5) empowers appellant to prescribe the maximum for other fees (except administrative), and Section 27(a)(6) confers certain powers as respects a type of company not involved in this case. Section 22(c) empowers appellant to issue general rules regarding sales load. While none of these powers has been exercised, their enumeration in the Act excludes the general claim on which the Commission proceeds in this case.

To say that the owner of stock in a service corporation may not sell at a price commensurate with its value and must sell at physical asset value, would require him, if he sold, to make a gift to the purchaser. Appellant admits that "a sale of a controlling stock interest in the corporate investment adviser or principal underwriter at net asset value, or a transfer of such control by gift without more, is proper, even though the advisory or underwriting agreement is thereby terminated under Section 15" (Br. 68). Yet, if any value in the stock in excess of net asset value belong to the Trust Fund, how can the stockholder properly give this away? Once it is admitted that the director-stockholder is free to dispose of his stock, and thus of all value it carries, he must be free to sell it for its realizable value.

If an owner cannot sell without giving away most of the value, he will hold the stock and let it pass by will or descent. The consequence would be absentee ownership of the service corporation by persons who might be entirely unqualified. As said in an article in 70 Harvard Law Review (April 1957), p. 986, entitled "The Sale of Controlling Shares" referred to at page 70, *infra:*

> "That the sale of controlling blocks of shares is a daily phenomenon of our economic order is evident from a casual reading of the financial pages. The writer is not aware of economic studies which purport to show the impact upon society and upon the shareholders themselves which would be caused by a policy generally restricting such transfers—although it seems obvious that if corporate managers were denied the right to profit from the sale of control they might well cling to the fruits of control long after outliving any usefulness they might have had to their corporations and to their fellow shareholders." (p. 1018)

Appellant speculates that a greater price for stock in a service corporation means hazardous policies. This is illogical. The greater the price, the more it is to the interest of the purchaser to have the service corporation serve the trust fund diligently and with skill,

for only by successful performance of its services may the service corporation expect to have the contract continue and thus earn compensation adequate to give a fair return to the purchasers of the stock. In all its speculations, appellant ignores the facts *of this* case. Under the contract between ISI and the Trust Fund, service fees are not based on the number of transactions *in the* Fund, or on the amount, kinds, or values of securities bought, sold or held by the Fund. Thus no manipulation of the Fund can increase ISI's remuneration. There can be no temptation to gamble or embark on hazardous programs. The fees are based solely on what the investors pay in (see p. 3, *supra*). The fees can grow only by an operation so successful as to attract investors.

In the article just mentioned the author, Professor Hill, further observes (p. 1018):

> "It is submitted that the legislatures and courts * * * would be more responsive to suggestions *for the elimination of real evils* than to suggestions designed to produce hypothetical benefits at unknown cost."

Professor Hill is here speaking of the sale of a controlling block of stock as respects the minority stockholders in the corporation whose stock is being sold. His remarks are doubly applicable here, as we show in section 9, *infra* (at pp. 65-71).

8. Appellant's analogy to the sale by a trustee of his office is a false one.

Many of appellant's citations and arguments relate to the attempted sale by a trustee of his office[27] and appellant would liken that situation to the sale of control of ISI (e.g., Br. 56 et seq.). This is patently a false analogy, because a trustee cannot sell his office at all, whereas a stockholder in a corporation may sell his stock.

Inherent in the very concept of a corporate fiduciary is the right to transfer the ownership of the fiduciary by transferring its

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27. Such are *Forbes v. McDonald,* 54 Cal. 98; and *Sugden v. Crossland,* 65 Eng. Rep. 620.

stock—and receive pay for it. Stock in trust companies is frequently sold; controlling blocks are sold. No case has ever suggested that this is an abuse of trust.

To say that a sale of controlling stock in a service corporation is to be treated like the sale by a personal trustee of his office defies common intelligence, particularly in view of the following:

(a) Congress specifically recognized that corporations may act as investment advisers and the like. This is implicit in the very provision that the transfer of a controlling block of the voting securities of an assignor of a service contract should terminate the contract. (Act, Sec. 2(a)(4) and Sec. 15) And see also the definition of "investment adviser", "principal underwriter", and "person", in Section 2(a) (19), (27) and (28). Appellant recognizes this. Its brief states (p. 43):

> "The contingency that the investment adviser or principal underwriter may be a corporation is likewise provided for in Section 2(a)(4). The Congress fully understood that, as disclosed in the Commission's investigation, sponsors and their allies might incorporate their professional talents and render their services to the investment company as agents or officers of the corporation to be engaged as the principal underwriter or investment adviser."

And again (Br. 97):

> "* * * the Congress specifically envisioned that investment advisory and principal underwriting services might be performed by persons not only as individuals but also through a corporation."

(b) Congress knew that corporations have stockholders.

(c) Congress knew that from time to time the stockholders would be selling their stock and that they might sell a controlling block. The Act contemplated such sales, because in Section 2(a) (4) (quoted p. 12, *supra*) *it stated the consequences viz., termination of the contract.*

(d) Congress further knew what everyone else knows, that one of the principal reasons for the existence of corporations is that an investor therein may transfer his interest in a manner and to an extent he could not do in the absence of the corporate arrangement.

The analogy to the sale by a trustee of his office thus fails at its foundation. Appellant cannot deny that the stock in a corporate fiduciary can be sold, whereas a trusteeship cannot be sold at all. But it would argue that if enough stock is sold to constitute control of the corporation, its price is subject to restriction. *This is not analogy. It is legislation. And it is legislation Congress did not choose to enact.*

9. Appellant's citations are not remotely relevant:—none holds that the sale of stock in one corporation is a breach of a fiduciary relation to another company or even purports to touch on the question.

With the underlying rationale of appellant's case exposed, the irrelevance of its citations is apparent. We have already mentioned some of them (pp. 52, 59, *supra*). Others involve the situation where a member of a class who assumes to exercise or enforce a class right seeks to sell it for his own profit,[28] or the

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28. In *Clarke v. Greenberg,* 296 N.Y. 146, 71 N.E. 2d 443 (Br. 64), a party commenced a stockholder's derivative action and then sold out to the defendant at a profit so as to permit dismissal of the case. The essence of the decision is that the plaintiff in a stockholder's suit enforces a corporate right.

In *Young v. Higbee Co.,* 324 U.S. 204 (Br. 63, 66), two stockholders objected to confirmation of a plan of reorganization in bankruptcy on grounds common to all such stockholders, and they took an appeal from confirmation. Success on appeal would benefit all. They sold the appeal to the adversaries so as to permit dismissal. The case merely held that members of a class "cannot avail themselves of the statutory privilege of litigating for the interests of a class" for their own benefit (p. 213). As said in *Young v. Potts,* 161 F.2d 597 (6 Cir.), after remand from the Supreme Court:

> "Potts is not held to account for the sale of his stock—he is held to account for selling out the interests of other preferred stockholders by the transfer of rights to the appeal so as to permit the purchaser of his stock to dismiss it. Bradley and Murphy were not interested in buying stock,—they were buying-off a dissident stockholder who, by his appeal, jeopardized a plan by which their junior interests were to be awarded a substantial share in the Higbee assets." (p. 600)

equally irrelevant "corporate opportunity" situation.[29] Another[30] simply held unenforceable a contract by the board of directors of a corporation to delegate all its powers, as the board, to another corporation. How far a board may delegate its powers is a subject all its own,[31] but it is not remotely relevant because the Investment Company Act expressly permits an investment company to contract with another corporation to perform the services involved in this case, as appellant's brief recognizes (see p. 64, *supra*).

A series of citations has to do with the rights of a corporation or its minority stockholders in the event of sales of their position by directors or management of *that* corporation, sometimes achieved by sale of stock and sometimes not. For a variety of reasons these cases are not in point. For example, they are largely "looting" cases, i.e., directors sell their positions knowing that the purchaser seeks control of the corporation in order to loot it and thereafter he does loot it.[32] Or they involve misrepresentations to

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29. *Irving Trust Co. v. Deutsch,* 73 F.2d 121 (2 Cir.). The principle is that directors of a solvent corporation may not take over for their own profit an opportunity available to the corporation of which they are directors. If ISI had advantageously bought securities for itself of a type the Trust Fund was set up to buy, there might be an analogy.

30. *Sherman & Ellis v. Indiana Mutual Casualty Co.,* 41 F.2d 588 (7 Cir.).

31. 2 Fletcher on Corporations, Secs. 495, 496; *Dyer Bros. Iron Works v. United Iron Works,* 182 Cal. 588, 594, 595; 189 Pac. 445.

32. In *Moulton v. Field,* 179 Fed. 673, one defendant "purchased" a management contract from the corporation's manager. Then, controlling the corporation, he caused it to buy from him an utterly worthless list of names for $200,000. The suit was to recover from him, for the corporation, that sum which had been taken from its treasury, not the sum paid by him to the former manager.

In *Bosworth v. Allen,* 168 N.Y. 157, 61 N.E. 163, the directors transferred their directorships to purchasers "whom they knew to be irresponsible and untrustworthy" (p. 163) and who thereupon wasted the corporate assets by payments to themselves and others. The gist of the case is stated thus (p. 164): "The defendants conspired to wreck the corporation of which they were directors, and to thereby make money for themselves."

In *Gerdes v. Reynolds,* 28 N.Y.S. 2d 622, after the directors sold their stock and their offices, the purchasers wasted and purloined the assets of

the minority,[33] or other special circumstances. All these citations are but exceptions to the general rule that the holder of a controlling block of stock may sell it for the best price he can, and it is immaterial that the price is enhanced by the control position of the shares. As said in 68 Harv. Law Review 1274, 1275:

> "It is generally held that a stockholder may dispose of his stock in such manner and for such price as he pleases, and it is recognized that the advantages inherent in control of a corporation may make the price paid for shares composing a controlling block greater than that paid for other shares * * *. However, the freedom of the controlling stockholder to dispose of his interest has been restricted where the sale was negligently or fraudulently made to persons who then *looted* the corporation. *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940); see *Gerdes v. Reynolds*, 28 N.Y.S. 2d 622 (Sup. Ct. 1941)."

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the company (p. 629); e.g., they went into the corporation's safe-deposit box, abstracted and sold one million dollars of securities (p. 642). Their plan was to acquire the company with its own assets (p. 645). The court said that "it would be illegal for officers and directors to resign and elect as their successors persons who they knew intended to loot the corporation's treasury" (p. 652), and held the same to be true where the circumstances put the selling directors on reasonable notice of the purchasers' unlawful purpose.

McClure v. Law, 161 N.Y. 78, 55 N.E. 388 involved a similar situation. In *Benson v. Braun*, 145 N.Y.S. 2d 711, 286 App. Div. 1098, the complaint was held sufficient, because, as it appears from the later opinion in the same case, 155 N.Y.S. 2d 622, where the suit was dismissed, the charge was one of sale with knowledge by the sellers of the buyer's intention to loot (p. 626).

Insuranshares Corporation v. Northern Fiscal Corp., 35 F. Supp. 22, was also a looting case, as appellant's brief acknowledges (p. 37, fn. 27, and p. 47). It was—

> "* * * a suit brought by a corporation against its former officers, directors, certain of its former stockholders, and others, to recover damages incurred by the corporation as a result of the sale of its control to a group who proceeded to rob it of most of its assets. * * *" (p. 23)

The purchasers' plan—

> "* * * was to strip the corporation of its valuable assets, leaving its mere shell to the remaining stockholders. The project was carried out with thoroughness and dispatch * * *." (p. 24)

And this was "a program to which [the sellers] assented." (p. 24)

33. E.g., *Porter v. Healy*, 244 Pa. 427, 91 Atl. 428.

Similarly, in *Seagrave Corp. v. Mount*, 212 F.2d 389, 395, (6 Cir.), the court agreed that "as a general proposition" "majority stockholders are at liberty to dispose of their shares at any time and for any price to which they may agree without being liable to other stockholders," and it noted "recognized exceptions to the general rule" of the types mentioned above.

To the same effect: *Tryon v. Smith*, 191 Ore. 172, 229 P.2d 251, and cases cited; *Keely v. Black*, 91 N.J. Eq. 520, 111 Atl. 22; *Benson v. Braun*, 155 N.Y.S. 2d 622, 625.[34] As said in *Securities and Exchange Commission v. Chenery Corp.*, 318 U.S. 80, 88:

> "As the Commission concedes here, the courts do not impose upon officers and directors of a corporation any fiduciary duty to its stockholders which precludes them, merely because they are officers and directors, from buying and selling the corporation's stock."

But it would be an imposition on the Court to explore the rule and its exceptions, because they relate to the duty of those in control of a corporation to the corporation itself or to the minority stockholders therein—not to outsiders. Not one case

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34. It was there said:

"* * * The general rule is that a stockholder may dispose of his stock at any time and at such price as he chooses. Recognition is given to the fact that the advantages which flow from control of a corporation may make the price paid for controlling shares greater than that paid for other shares. [citations omitted] * * * The purpose of the rules restricting transfers of controlling interests is to prevent transactions tainted with bad faith, intent to defraud or negligence on the part of those possessing control. In the absence of such elements it is desirable that control of a corporation be readily transferable 'so that persons with ideas for improving a business might be able to put their ability to work'. * * * When ownership of controlling stock changes hands, a change in the board of directors is generally expected. * * * It is true that officers and directors may normally resign from office when they please. * * * Thus it is legitimate for those selling controlling shares, in connection with the sale of their stock, to resign as directors and to use their influence to bring about resignations by a majority of the board so as to facilitate the taking over of control by the purchasers."

suggests that the majority stockholders of a corporation have some duty, in respect of their shares to outsiders with whom the corporation has a service contract.

The extraordinary nature of appellant's claim may be seen by considering the special situation on which it rests so heavily, *Perlman v. Feldmann,* 219 F.2d 173 (2 Cir. 1955). There the corporation was a manufacturer of steel, and during the steel shortage of the Korean War period the controlling interests were able to get a large premium for their stock because the buyer, a user of steel, wanted in this way to get an inside track on buying steel without paying gray market prices. The opportunity of charging gray market prices was said to belong to the corporation, and the majority stockholders had no right to sell it for their own profit.[35]

The case has been severely criticized by commentators. In the article on Corporations in the "1955 Annual Survey of American Law" (N.Y. Univ. School of Law), by De Capriles and Prunty, it is said that "already it has elicited controversial law review comment" (p. 340),[36] and the authors conclude, "We agree with Judge Swan's dissent" (p. 342).[37]

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35. That the opportunity of acquiring steel in a time of short supply was the gist of the case is clearly shown by the Findings of Fact entered after remand by the District Court on July 18, 1957. Thus the court found: "49. The dominant motive * * * in seeking to purchase Feldmann's controlling stock interest * * * was to obtain a continuing source of steel supply. Feldmann knew during the negotiations that such was their motive."

36. Among such comment is a long case note in 40 Cornell Law Quarterly, 786, which expresses the view that the "reasoning of the court" leads to a

> "result [which] is repugnant to present day concepts of stock transferability, and * * * should be rejected."

37. They quoted the following from that dissent (219 F.2d at 178): "My brothers' opinion does not specify precisely what fiduciary duty Feldmann is held to have violated or whether it was a duty imposed upon him as the dominant stockholder or as a director of Newport. Without such specification I think that both the legal profession and the business world will find the decision confusing and will be unable to foretell the extent of its impact upon customary practices in the sale of stock."

It is not our purpose to argue about the correctness of *Perlman v. Feldmann,* since it relates to the fiduciary relation of controlling stockholders to minority stockholders in the same corporation. The significance of our comment is this: Finding in the Act no prohibition of sales of stock in a service corporation, appellant seeks to drag it in through Section 36. To this end it asserts that by Section 36 Congress intended to confer power on the Commission and to grant jurisdiction to the Courts measured by settled principles of equity jurisprudence. And then it assumes that, by a statute enacted *in 1940,* Congress not only intended to adopt as that measure an extraordinary and controversial decision, under Indiana law, first emanating 15 years later *but further intended to apply it to a wholly different set of relationships,* governed by an entirely different rationale and an entirely different type of regulation specifically and explicitly enacted by Congress.

In an article in 70 Harv. Law Rev. 986 (April, 1957) entitled "The Sale of Controlling Shares", the author, Professor Hill, refers to Adolph Berle's theory that one who sells a controlling interest in a corporation sells an asset of the corporation and states that this theory has not been endorsed by any court (p. 987). The article in "1955 Annual Survey of American Law" referred to above describes this as "one of Professor Berle's less felicitous metaphors" (p. 341). Yet appellant here would extend that theory into a new dimension by asserting that sale of controlling shares in a service corporation is the sale of an asset of the Trust Fund! And appellant would carry this theory backward into the mind of Congress 17 years ago.

Where shareholders sell a controlling block of stock, the minority stockholders in *that* corporation *must accept the situation.* Their own investment thus becomes subjected, willy-nilly, to the management of the purchasers. This fact is the basis of equity's concern in the special situations noted above. *But the investors in an investment company are not compelled to accept the purchasers*

of control of a service corporation for any purpose at all, because Congress has provided that the transfer of control of the service corporation terminates the service contract. If the investors do accept the new situation, they do so voluntarily by voting to reinstate the service contract. And it may be terminated at any time on 60 days' notice by the investors or by the board of directors of the Trust Fund (Act, Sec. 15(a)(3)). This unusual protection, deemed adequate by Congress, puts the investors in a position to protect themselves and distinguishes the cases of sale of corporate control.

Again, when majority stockholders exact a premium for control of a corporation, the minority stockholder in *that* corporation finds the value of his own stock affected. But when controlling shares in the Service Corporation are sold, the value of an investor's participation in the Trust Fund is not affected at all. The Trust Fund here was an "open-end" company as defined in Sections 4 and 5 of the Act (R. 5, para. 6). An open-end company is one in which the investor may have his participation redeemed on demand at a price based on the current market value of the securities held by the investment company (Act, Sec. 5(a)(1), Sec. 2(a)(31)). As appellant concedes (Br. 4), "Since the Trust Fund is an open-end company, its Participation Agreements are subject to redemption at the option of the investor upon terms specified in the Agreement." The price at which ISI stock is sold has no bearing on the value of the investor's interest in the Trust Fund.

10. Under the facts of this case there was no transfer of control of the Trust Fund, because it has its own Board of Directors.

Appellant's argument is based on the idea of transfer of control *of the Trust Fund.* As we have seen, this ignores the Act, which makes such transfer impossible (see p. 29, *supra*). Moreover, the argument ignores the facts of this case. The Trust Fund has its own Board of Directors (p. 13, *supra*). Under the Act, a majority of the directors of the Fund must be unconnected with ISI (Act,

Sec. 10(b)(2)), and such is the actual fact (see R. 141, 142). The Fund has 7 directors, ISI has 9, and only 3 are common to both boards, Elwood Murphey, Donald B. Rice and Leland M. Kaiser. Five of the Fund's 7 directors are not now and never have been stockholders of ISI, viz., Howard D. Ainsworth, Elwood Murphey, Brayton Wilbur, E. R. Leach and Judge A. J. Woolsey of the Superior Court, Alameda County, California. These men are substantial investors in the Trust Fund, owning around a quarter of a million dollars of participation agreements (R. 35, 36). A sixth director of the Fund, Mr. Rice, owns but 6/10 of 1% of ISI's stock (Br. 35, 36). Accordingly, neither sellers nor purchasers of stock of ISI control the Fund. The Directors of the Fund control it, and the stockholders of ISI do not elect the directors of the Fund. Those directors are elected by the investors.

While the creation of a Board of Directors of the Fund occurred after the suit was filed, it had been proposed before. If a new service contract had not been voted by the investors, appellant would lack even an excuse to argue that the stock purchasers had acquired control of the Trust Fund. Yet it was contemplated that a board of directors for the Fund would be created simultaneously with any approval of a new contract. The last stock sold was the 16,000 shares which Leach contracted in July 1956 to sell, and the consummation of that sale could not take place until the proposed amendments to the Trust Agreement were either adopted or rejected (see p. 8, *supra*). It is the present fact that controls. As said in *Sinclair Refining Co. v. Jenkins Co.,* 289 U.S. 689, 698:

> "Experience is then available to correct uncertain prophecy. Here is a book of wisdom that courts may not neglect. We find no rule of law that sets a clasp upon its pages, and forbids us to look within."

Hereafter, any decision to terminate the service contract or to reinstate it will rest with the independent Board of Directors of the Fund and, alternatively, with the investors. The directors are elected by the investors in the Fund, and the proxy machinery for

obtaining the investors' votes is under their jurisdiction and not that of ISI.[38]

E. ISI committed no act claimed to be wrongful.

ISI is a "person" governed by Section 36, since it is the investment adviser and principal underwriter of the Trust Fund.

But ISI has committed no act of any kind which is or could be charged as being misconduct or abuse of trust. The alleged misconduct consists of the sale of certain stock *in ISI* by certain of its stockholders at certain prices. *This is not an act of ISI.* We point out in the Statement of the Case that the original complaint nowhere even charged ISI with the *conclusion* of misconduct or abuse of trust. That charge was added by amendment to the complaint, but even the amendment added no allegation that ISI had committed any act (see pp. 11, 12, *supra*).

Appellant argues thus (Br. 95; also 24):

> "Liability is also imposed upon a fiduciary who condones activities, detrimental to the trust, committed by those employed to assist the fiduciary in managing the trust estate. See *Mosser v. Darrow,* 341 U.S. 267 (1951) * * *."[39]

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38. Nor did the purchasers of ISI stock have anything to do with the machinery for obtaining proxies of the investors to vote on the proposals contained in Exhibit B to the complaint (R. 18). The complaint does not allege that they had, and Exhibit B shows (R. 35, 36) that 11 of ISI's 13 directors at the time the proxies were sought had been on the Board since before any sale of stock was made.

Moreover, not a single stockholder who either bought or sold or owned any shares had participated in the action of ISI's board in submitting the matter to the investors (R. 80). This is an uncontradicted objective fact.

39. This is preceded by another statement (Br. 95), so remote from this case that it requires but passing comment:

> "It is familiar doctrine that one who, not otherwise under any fiduciary obligation, participates in the commission of a breach of trust, is liable for the consequences of the breach. See *Jackson v. Smith,* 254 U.S. 586 (1921)."

In *Jackson v. Smith,* a court receiver who had the affirmative duty to try to realize the largest possible amount from a certain asset conspired with two others that one of them should bid it in at an auction and, if he succeeded in buying it, the receiver would contribute to the cost and share in the profits. The conspirators were held equally liable with the receiver.

This sentence possesses two vices. It relates to a rule not even applicable to this case, and it overstates that rule. *Mosser v. Darrow* applied the doctrine of *respondeat superior.* A trustee who knowingly permitted his agents, in the performance of the *trustee's duties,* to profit at the expense of the trust was held liable.[40] The actions which constituted wrongdoing were his actions. But the act of a stockholder in selling *his* stock is no act of the corporation. Mosser could control his own employees in the performance of their duties for him, but ISI could exercise no control over its stockholders in respect to the sale of their stock.[41]

Appellant attempts a reverse disregard of corporate entity.

The usual doctrine of disregard of the corporate entity is one which permits the acts of a corporation to be deemed the acts of its stockholders and holds them liable for what it did. Appellant makes an argument (Br. 99, 100) which seeks to hold the corporation responsible for what *some* of its stockholders did individually, relying on *State ex. rel. Attorney General v. Standard Oil Co.,* 49 Ohio St. 137, 30 N.E. 279 (1890). That was a *quo warranto* proceeding against Standard Oil Company of Ohio to forfeit its franchise because of its participation in the old Standard Oil Trust. There it was alleged (p. 280, 1st col.) and admitted (p. 287, 1st col.) that "*all* of the owners and holders of its capital stock, including all the officers and directors of said defendant

40. In *Mosser v. Darrow* a court-appointed reorganization trustee engaged in buying up for the trust its own securities. His duty was to buy them at the lowest possible price. He entered into an arrangement with two employees which permitted them to buy these securities tendered to the trust, on their own account, and to resell them to the trust at a profit. Had he done so himself he clearly would have been liable.

41. In the same vein, appellant cites Section 48(a) of the Investment Company Act (Br. 95, fn. 78). That section merely makes it unlawful for a person to cause an act to be done "through or by means of any other person which it would be unlawful for such person to do." But the selling of stock was not an act of ISI, directly or indirectly. Nobody sold stock owned by ISI. The stockholders, not ISI, sold their stock. Section 48 imposes criminal sanctions, and penal acts are strictly construed.

company, signed said agreements" whereby the signatories delivered their stock to the Standard Oil Trust and received trust certificates. The purpose was to use Standard Oil Company of Ohio in a conspiracy to restrain trade, and this is the background out of which the term "trust" came to be applied to illegal combinations in restraint of trade. The trust agreement provided that the corporation should be used, and it was used, to carry on the illegal activities. The gist of the court's reasoning was this (p. 288):

> "Now, * * * it will be observed that this contemplated, and could not have accomplished *without, corporate action.* * * * and this was to be accomplished by the obligation imposed on its members and stockholders, *all* of whom are parties to the agreement, to authorize and require the directors and managers to make the transfer. The property and assets of the corporation could only be transferred by a corporate act, and the agreement could not, in this respect, be carried into effect, other than by such corporate act, and clearly indicates that the purpose of the stockholders of the defendant in becoming a party to it *was to affect their property and business as a corporation;* in other words, was to act *in their corporate, and not in their individual, capacity.*"[42]

This case is not in point, for the stockholders were using the corporation as a tool, and all the stockholders were involved.

In the present case there were five other stockholders of ISI besides the defendant directors, owning 28% of its outstanding stock (R. 7, para. 15). Appellant comments that 8 of ISI's stockholders participated in sales (Br. 96, 97). But 4 of the selling stockholders were not directors and were not sued, and appellant has never charged that they were guilty of a "gross abuse of trust." Its own theory will not permit it to do so, for Section 36 does not reach stockholders who were not directors or officers and occupy

42. Similar in its facts and reasoning is another case cited by appellant (p. 100, fn. 80), *People v. North River Sugar Refining Co.*, 121 N.Y. 582, 24 N.E. 834 (1890), involving the Sugar Trust.

no office subject to an injunction under that section (see p. 10, *supra,* and p. 78, *infra*).

Nevertheless, appellant would add the *legal* activities of the non-directors to the sales of other stockholders and then impute the whole to the corporation as *its* act and call it illegal!

To deprive ISI of its service contract would visit a penalty on stockholders who are not even alleged to have committed any act of wrongdoing whatever, on non-director stockholders, on those who sold no stock, and on the buyers as well. Appellant seeks to justify its effort to punish those innocent even under its own theory by a curious chain of reasoning (Br. 101, 102). ISI's stockholders, it says, have no vested right in having its contract with the Trust Fund continue; the right of designating who shall be the service corporation belongs to the Trust Fund and its investors; and on a termination of the contract by a sale of a controlling stock of the service corporation, "a minority stockholder cannot complain if, as a consequence, new contracts should be made with someone other than ISI" (Br. 102). All this is true, but the investors *have* exercised their right of designation by reinstating the contract, and they have *not* chosen to make a contract with someone else! The Commission wishes to veto their choice by enjoining ISI from acting.

Finally, appellant advances a self-defeating argument. It refers to Section 9(a)(3) of the Act,[43] and avers (Br. 98):

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43. Section 9(a) (1), (2), and (3) reads:

"Sec. 9. (a) It shall be unlawful for any of the following persons to serve or act in the capacity of officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company, registered unit investment trust, or registered face-amount certificate company:

"(1) any person who within ten years has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or

> "Section 9(a)(3) thus represents a Congressional determination that the corporate fiduciary is not permitted to remain in its position of trust if it retains within its organization an affiliated person involved in any wrongful securities transactions, the underlying assumption being that the retention of such person represents a danger to the investment company and its public security holders."

But Section 9(a)(3) is a very explicit provision and not so broad as appellant describes it. It makes it unlawful for a company to act as an investment adviser or principal underwriter for an investment company, if an "affiliated person" is "ineligible" to serve the investment company because he has been *convicted* of a felony or misdemeanor or has been *enjoined* by reason of misconduct from acting in certain enumerated capacities. No defendant has ever been convicted or enjoined, the complaint has not sought to enjoin ISI under Section 9(a)(3), nor is there any basis on which it could seek to do so. That section demonstrates, once again, that when Congress wished to prohibit specific conduct it knew how to say so explicitly. When it wished to forbid a company from acting because of individuals in its employ, it said so. *But* it did not ordain in Section 36 that the acts of individuals should be deemed acts of a corporation with which they are affiliated.

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employee of any investment company, bank, or insurance company;

"(2) any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, or investment adviser, or as an affiliated person, salesman, or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security; or

"(3) a company any affiliated person of which is ineligible, by reason of paragraph (1) or (2), to serve or act in the foregoing capacities."

F. The remedy provided by Congress in Section 36 demonstrates that the Section has nothing to do with sales of stock in a service corporation.

The non-liability of the Service Corporation under Section 36 for sales of stock by its stockholders, just discussed, leads to a further consideration.

1. The only remedy available under Section 36 is an injunction against those committing the gross abuse from continuing in the capacities in which they committed it.

Appellant's brief is correct when it observes (pp. 27, 87) that Section 36

> "is limited to a civil remedy for an injunction",

and (p. 69)

> "actions under Section 36 are specifically limited to the civil remedies there prescribed".

Section 36 is unique and unlike the other sections of the Act. It does not declare "gross abuses" or "gross misconduct" *unlawful.* It did not make an act of gross abuse a federal offense. Nor did it enact that "gross abuse" should constitute conduct for which the S.E.C. can sue and obtain any kind of civil relief thought to be appropriate. Section 36 *merely grants a limited and specific federal remedy to enjoin certain persons from acting in certain capacities in certain events.* This is plain on its face, and we refer again to the text of the section, quoted at p. 6, *supra.*

Elsewhere in the Act Congress declared certain kinds of conduct unlawful (e.g., embezzlement, Sec. 37,[44] and see Sections

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44. 15 U.S.C. Sec. 80a-36, which reads:

"Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 80a-48 of this title. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts."

17, 18) or prohibited certain types of conduct (e.g., Section 26). And in Section 49 it provided that any person who wilfully *violates* any provision of the Act shall upon conviction be fined and imprisoned.[45]

Section 36 had its origin in Section 17(e) of the original bill introduced in Congress. That section provided:

> "Any gross misconduct or gross abuse of trust in respect of a registered investment company, on the part of any person registered under section 9 as an affiliated person of or principal underwriter for such company, shall be unlawful." (S. 3580, 76th Cong., 3rd Sess.)

As so written, violation would subject the guilty person to the penal provisions of Section 49. As we have seen (p. 34 above), and as appellant concedes (Br. 87), the Act as passed was a compromise measure agreed to by the S.E.C. and representatives of the industry. The latter objected to proposed Section 17(e), and it was therefore revised into the present Section 36. The leading article on the Act, by Mr. Alfred Jaretzki, Jr. (see p. 36, *supra*), states of Section 36:

> "This provision grew out of one in the original bill which made any gross misconduct or gross abuse of trust unlawful. The industry objected to it on the ground that such an indefinite standard should not be made the basis of a federal offense." (26 Wash. U.L.Q. 303, 344)

Appellant admits that the "gross abuse" or "gross misconduct" of Section 36 cannot be the subject of penal action under Section 49, but argues that "only the criminal sanctions were narrowed and limited", and that so far as civil sanctions are concerned, "the same breadth and scope must be attributed to Section 36" as to old Section 17(e) (Br. 87, 88).

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45. 15 U.S.C. Sec. 80a-48:

> "Any person who wilfully violates any provision of this subchapter * * * shall upon conviction be fined not more than $10,000 or imprisoned not more than two years, or both;".

This is incorrect. As noted, Section 49 provided that any person who wilfully *violates* any provision of the Act shall upon conviction be fined and imprisoned. Section 42(e)[46] empowered the Commission to sue in equity "to enjoin such acts or practices and to enforce compliance" in case of any *violation* of the Act. Patently Sections 42(e) and 49 are *in pari materia.* Conduct which cannot be made the subject of penal proceedings under Section 49 cannot be proceeded against civilly under Section 42(e). If Section 36 had been enacted in the form of proposed Section 17(e), a "violation" would subject the violator both to the penal provisions of Section 49 and to any appropriate relief in a civil suit by the Commission under Section 42(e). But as the Act was passed, "gross abuse" is not the subject of criminal sanctions, and it is not the subject of civil sanctions (a) unless the act of "gross abuse" is also prohibited specifically in some other section than Section 36, (b) except for the remedy which Section 36 itself states. The change from a prohibition to a specific remedy alters the role of Section 36 in the Act.

The specific remedy is an injunction against the person who commits a "gross abuse of trust" or "gross misconduct" from continuing in the capacity in which he committed it. That is all.

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46. 15 U.S.C. Sec. 80a-41(e), which reads:

"Whenever it shall appear to the Commission that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this subchapter and sections 72(a) and 107(f) of Title 11, or of any rule, regulation, or order thereunder, it may in its discretion bring an action in the proper district court of the United States * * * to enjoin such acts or practices and to enforce compliance with this subchapter and sections 72(a) and 107(f) of Title 11 or any rule, regulation, or order thereunder. * * * The Commission may transmit such evidence as may be available concerning any violation of the provisions of this subchapter and sections 72(a) and 107(f) of Title 11, or of any rule, regulation, or order thereunder, to the Attorney General, who, in his discretion, may institute the appropriate criminal proceedings under this subchapter and sections 72(a) and 107(f) of Title 11."

The House Committee Report on H.R. 10065, which became the Act, makes the following statement about Section 36:[47]

> "36. *Injunctions against gross abuse.* This section authorizes the Commission to bring an action in a proper court of the United States to enjoin certain affiliated persons and underwriters of investment companies from acting in those capacities, alleging that the defendant or defendants have been guilty of gross misconduct or gross abuse of trust in respect of the investment company with which he or they are associated."

2. An accounting of profits is not possible under Section 36.

The complaint prays for an accounting of the profits made by Leach, Lonergan, Carr and Haight from the sale of their stock, and appellant's brief asserts (Br. 94):

> "By the same token the court whose jurisdiction is invoked under Section 36 may require that those initiating the wrongful acts should account for the benefits derived as a consequence of the breach of trust. This construction of the statute is clearly essential, if Sections 15 and 36 are to fulfill the purposes that the Congress intended * * *"

We have already noted the elementary rule that it is for Congress to determine how rights it creates shall be enforced, and when it declares the remedy, that remedy is exclusive (see *Wilder Mfg. Co. v. Corn Products Co.,* 236 U.S. 165, 174; *Switchmen's Union v. Board,* 320 U.S. 297, 301; *Bruce's Juices v. American Can Co.,* 330 U.S. 743, 750; *62 Cases of Jam v. United States,* 340 U.S. 593, and the quotations from these cases at pages 43-46, *supra*).

The question is not merely one of *lack of power of the Commission to seek* an accounting. It is also one of *lack of jurisdiction of the court to grant it at the suit of the Commission.* The Act does not empower the Commission to seek, nor confer jurisdiction on

47. Report No. 2639, 76th Congress, 3rd Session, p. 26.

the courts to grant *at the Commission's suit,* any and all types of relief in the event of a gross abuse of trust. Section 36 merely confers jurisdiction on a federal court *at the suit of the Commission* to grant a certain type of injunctive relief against certain persons occupying certain capacities.

The only argument advanced by appellant to support the claim that it can secure an accounting is in its footnote 77 on p. 94, where it states:

> "See *Aldred Investment Co. v. SEC,* 151 F.2d 254, 261 (C.A. 1, 1945), certiorari denied, 326 U.S. 795 (1946), where the court said: 'Section 36 invokes the equity power of the Federal Court and that calls into play its inherent powers where necessary to do justice and grant full relief.' "

This contention, we submit, is plainly incorrect.

The principle that where the equity jurisdiction of a court is called into play, the court has inherent power to grant full relief might be applicable *if* this were a suit brought by a private person who had suffered damage or been deprived of a property interest by acts of a defendant. But the Commission is the plaintiff here, and the Commission is not an injured party. *It is merely an agency of the government empowered by Congress to seek a certain kind of relief. It can go no farther than Congress empowered it to go.* As said in *Regents v. Carroll,* 338 U.S. 586, 597: "As an administrative body, the Commission must find its powers within the compass of the authority given it by Congress."[48]

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48. The Court here cited *Amer. School of Magnetic Healing v. McAnnulty,* 187 U.S. 94, where it said:

> "Otherwise, the individual is left to the absolutely uncontrolled and arbitrary action of a public and administrative officer, whose action is unauthorized by any law and is in violation of the rights of the individual." (p. 110)

It also cited *Helvering v. Sabine Trans. Co.,* 318 U.S. 306, where the Court said (p. 311):

> "We think the regulations [of the Treasury] are in the teeth of the unambiguous mandate of the statute, are contradictory of its plain terms, and amount to an attempt to legislate."

In the *Aldred* case, for abuses of trust by one Hanlon, the owner of most of the stock of the investment company (called the Trust) who had elected himself and associates trustees, the court enjoined them from continuing as officers or trustees of the Trust and appointed a receiver. While the court overruled defendants' contention that it could not appoint a receiver, the situation was different from here.[49] By enjoining the wrongdoers from exercising their control, the court left the Trust without any officers or trustees to operate it, and a receivership was therefore necessary to protect the Trust. The reasoning is lucidly set forth in (a) the brief filed in that case in the Court of Appeals by the Commission in June 1945, and (b) a brief filed by it in November 1946 in the later case of *Bailey v. McLellan,* 159 F.2d 1014 (No. 4197, 1 Cir., Oct. Term 1946) which concerned allowance of counsel fees for services in the *Aldred* litigation.

The Commission's brief in the *Aldred* case said (p. 43):

> "The Court below found that Hanlon and most of his associates had grossly abused their trust and enjoined them from continuing as officers or trustees of the Trust. In substance, the judgment was that Hanlon and his associates could not be trusted with the management of other peoples' money. However, such an injunction alone would be thoroughly ineffective so long as Hanlon retained the controlling stock of the Trust. For an injunction which permitted Hanlon to nominate another group of trustees subject to his domination and control would merely perpetuate the situation which resulted in the abuse and might be expected to result in a repetition of the suit."

In its "Memorandum of the Securities and Exchange Commission, Appellee" in *Bailey v. McLellan,* the Commission said (p. 3):

> *"It should be emphasized that the Commission's suit was brought pursuant to a statutory duty, and its action was*

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49. Defendants there did not refer to the limited scope of Section 36 but based their argument on different considerations.

directed solely to ensuring that the Trust as a whole be safeguarded against the individuals who were, as it believed and has been conclusively determined, *subordinating the welfare of the Trust to their own selfish interests. The request for the appointment of a receiver was in no sense separable from the relief sought against the individual wrongdoers, but was made and granted to ensure the effectiveness of the injunction against the individual defendants.* It did not rest, as might appear from appellants' brief, primarily upon the insolvency of the Trust, as such, but upon the necessity of protecting the Trust from further abuse on the part of the principal wrongdoer, Hanlon. *Thus, the injunction against the individual defendants and the appointment of the receiver were in essence merely opposite sides of the same coin."*

The appointment of a receiver to fill the gap caused by removal by injunction of all officers may be but an incident of the injunction authorized by Section 36. But to order defendants here to account for their "profits" would not be an incident. It would be a new and different sanction. It would be legislation. We submit there is no authority for it and no jurisdiction under "the axiom that clear statutory mandate must exist to found jurisdiction." *Carroll v. United States,* 354 U.S. 394, 399.

3. The remedy provided by Section 36 is a test of what that section was intended to reach.

Bearing in mind (1) the fact that in Section 15 Congress *explicitly* dealt with the matter of transfers of control of a service corporation (see pp. 28, 37, *supra*), plus (2) the foregoing history of Section 36, and (3) the limited remedy it prescribes, we think it is beyond reason to contend that Section 36 has any relevance at all to the sale of stock in a service corporation.

The sole remedy available under Section 36 is an injunction against continuance as an officer, director or adviser of the

investment company. But if a sale of stock in a service corporation is deemed to be a "gross abuse of trust" in respect of the investment company, note how paradoxical the remedy would be! The "gross abuse" is supposed to lie in the fact of "transfer of control". Yet the remedy would oust the person from office and thus compel that very transfer of control which is supposed to constitute the wrongdoing. To oust one who steals, embezzles or engages in self-dealing with the beneficiary's funds is an apt remedy;—the punishment fits the crime. But to force a change in management as punishment for making a change in management potential is to turn things topsy-turvy. Here Leach, Lonergan, Haight and Carr are still directors of ISI. Yet appellant wishes to force them out!

Appellant's brief avers (p. 83) that it "stands to reason that * * * Congress intended to adopt measures equal to the task and purpose". We agree. Our difference is that appellant attributes to Congress a purpose broader than the measure it adopted, and then, with procrustean perversity, tries to stretch the measure to fit the imagined purpose. But the measure which Congress chose is explicit and precise, and it simply will not countenance the idea that sales of stock in a service corporation were ever contemplated by Congress as falling under Section 36.

Moreover, in relying on Section 36 as a means of regulating sales of stock of a service company, appellant is constrained to say that a sale of such stock at more than asset value constitutes misconduct only if made by a director-stockholder, because Section 36 does not apply to a stockholder holding no office. But if Congress intended the Trust Fund to be entitled equitably to any value in the stock of a service company above its asset value, there is no reason for its drawing a distinction between a director-stockholder and any other stockholder. Plainly, appellant is assigning a function to Section 36 that Congress never envisaged.

G. The individual defendants, directors of ISI, are not subject to Section 36.

All analyses of Section 36 converge to the same conclusion that sales of stock in a service corporation do not come under it. Examination of the section shows a further reason why appellant's theory is built on quicksand.

1. Section 36 applies only to persons acting in certain capacities and in respect of an investment company.

We respectfully direct the Court's attention again to the text of Section 36, quoted on page 6, *supra.* It is plain that it relates solely:

(1) to a "person serving or acting in one or more of the following capacities" and

(2) acting in that capacity "in respect of any registered investment company". The capacities are these:

- (a) An officer of the registered investment company;
- (b) A director of the registered investment company;
- (c) A member of an advisory board of the registered investment company;
- (d) The investment adviser of the registered investment company;
- (e) A depositor of the registered investment company;
- (f) Principal underwriter of certain kinds of investment companies.

Appellant fails to confront the initial question: In which of the capacities noted in the foregoing breakdown are Leach, Lonergan, Carr and Haight to be found? *The answer is that they fall in none of them.* The "registered investment company" is the Trust Fund, *not ISI* (R. 5, para. 6). Since ISI is not the investment company, Section 36 does not apply to stockholders, officers or directors *of ISI,* and Leach, Lonergan, Haight and Carr were not officers or directors or members of any advisory board *of the Trust*

Fund. Nor were they its investment adviser. As appellant concedes (Br. 91) "ISI is, of course, the investment adviser, depositor and principal underwriter for the Trust Fund".

It follows that their sales of their stock in ISI do not fall under Section 36. The only case cited by appellant on Section 36 is *Aldred Investment Trust v. SEC,* 151 F.2d 254 (discussed at p. 52, *supra*), where the individuals charged with wrongdoing were trustees of the *trust fund itself.*

We do not mean to say that *no* act of a director of a *service corporation* can fall within Section 36. We emphasize that Section 36 relates to activities of persons in certain capacities when acting *"in respect of* [the] registered investment company." When the human beings who are the officers or directors of a service corporation act *for* it, i.e., act in their capacity as *its* agents, performing *its* work, these acts would constitute *its* acts, and if they were done in respect of its duties toward the investment company, their acts would constitute its acts "in respect of [a] registered investment company". This would comprise buying or selling securities for the Trust Fund or selling participations in it. But when they act in their individual capacities, selling their own stock to outsiders, their acts are not its acts and cannot fall under Section 36.

This is precisely what the District Court had reference to when it said in its opinion (R. 147):

> "In my opinion, no dereliction or even misconduct of officers or directors of Service Company within the area of its own independent affairs falls within the reach of Section 36. That the Congress clearly intended to so limit the reach of Section 36, *as it clearly did in precise language,* is evidenced by the fact that Section 36, when first considered by the Congress, applied to misconduct and abuse of trust generally."

In short, as a matter of plain English, the very language of Section 36 is in accord with our presentation in Part D, pp. 47-73, *supra.* Congress did not extend Section 36 to the directors of a

service corporation, because they fall outside the evil to be reached.[50]

Other conduct by directors or officers of a service corporation might be subject to condemnation under the Act, but not by virtue of Section 36. They would fall under other sections of the Act. For example, a director or officer is defined by Section 2(a)(3) (quoted at p. 92, *infra*) as an "affiliated person" of the company of whom he is an officer or director; and Section 17 prohibits an affiliated person of an investment adviser from buying from the investment company or selling to it, or borrowing from it (and see Section 9). Thus a director or officer of a service corporation cannot engage in dealings *with* the investment company. We fully agree with appellant that the Act frowns on attempts of the officers or directors of a service corporation to deal with a trust fund's property or to profit at its expense. But these prohibitions were specific. They were not left to Section 36, they do not fall under Section 36. Thus Senate Report No. 1775, from which we have quoted before, stated (p. 14):

> "In the future, persons who are officers, directors, investment advisers, etc., or persons affiliated with such persons may not, as principal, knowingly sell to or purchase from any investment company any securities or other property or borrow from any such investment company. Provision is made for certain exceptions with respect to transactions involving

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50. Appellant refers (Br. 92) to a remark of the District Court made during a colloquy with defendant's counsel and suggests that the court indicated—

> "that if the transactions constituted gross misconduct or gross abuse of trust in respect of the Trust Fund, Section 36 would apply to appellees (R. 157-158)."

The colloquy was precisely in accord with the discussion above. While the whole of it does not appear in the printed record what does appear (R. 157-8) shows the fact. A sale by a stockholder in a service corporation cannot constitute gross abuse of trust or gross misconduct in respect of the trust fund. The language of Section 36 does not cover such persons in respect of selling their stock, because there was no need for language which would. The specific language of the section was aptly selected to achieve the purpose of the section and does not countenance the imputation to Congress of a broader purpose.

> the company's own security issues and for transactions exempted by the Commission (sec. 17)."

It hardly need be added that no conduct of the kind referred to occurred in this case.

2. Appellant's assertions about "evasion" are based on pure assumptions about what Congress intended.

Appellant's answer, essentially, is its same old question-begging *assumption* about what Congress intended. It may be epitomized in appellant's own phrases and epithets:

> "In our view, the policy of the Congress against trading in investment advisory or principal underwriting contracts, and the related fiduciary standards and sanctions under Section 36, cannot be evaded as a consequence of incorporation." (Br. 92; similar statement on p. 23)
>
> "Appellees' contention in effect is that immunity from Section 36 can readily be obtained, if the investment advisory and principal underwriting functions of the Trust Fund are performed by them through a separate corporation such as ISI, and the sale of the succession is effected by a sale of stock control of ISI." (Br. 92)
>
> "* * * the tour de force which appellees contrived here. * * *" (Br. 93)
>
> "* * * ready means for evading the statutory policy." (Br. 95)

Since Congress recognized the right of a corporation to be an investment adviser (see p. 64, *supra*), it is not an "evasion" or a "tour de force" for a corporation to be an adviser. Appellant simply lifts itself by its own bootstraps, by *assuming* that Congress was interested in regulating the price at which directors of a service corporation sold their stock in *that* company. The mode of reasoning is backwards, for it starts on the premise of a congressional policy, which it draws from the circumambient air, and from this it deduces the prohibitions of the Act. But one must deduce the policy from the prohibitions of the Act.

Wherever individuals act *as directors* of ISI relative to the performance of ISI's duties under the Service Contract, their acts would be *its* acts, which do fall under Section 36, and there *could* not be an evasion. Whenever individuals who happen to be directors of ISI act in their capacity of shareholders in ISI in selling their own stock, their acts are *not* its acts and do not pertain to ISI's fiduciary duties, and there is no prohibition to be evaded.

3. The fact that the directors of ISI may be fiduciaries to the Trust Fund does not bring them under Section 36.

Appellant misconceives the issue. Much of its argument is predicated on the claim that the directors of ISI had a fiduciary relation to the Trust Fund.[51] (E.g., p. 94) But the question is not whether they are fiduciaries, but what does Section 36 say? It does not state that it applies to *all* who can be said to be fiduciaries to an investment company. It explicitly defines the precise fiduciary capacities to which it applies.

For example, appellant argues that ISI exercised all the management functions of the Trust Fund[52], and that the directors of ISI should therefore be regarded as falling under Section 36 (Br. 100, 101). But Congress knew that some investment companies have no directors of their own. More than once *Congress made express provision for unincorporated investment companies without boards of directors* when it thought provision appropriate. For example, subdivision (h) of Section 10 provides that certain regulations of that section affecting the directors of an investment company shall apply to the directors of the depositor or investment adviser of the investment company:

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51. Such is the utmost significance that can be attached to citations like *Ripperger v. Allyn*, 25 F. Supp. 554, and *Southern Pacific Co. v. Bogert*, 250 U.S. 483.

52. This was never true, for there has always been the trustee, Pacific National Bank of San Francisco (see R. 22). Moreover, the fact ceased to have any truth at all before the consummation of the sale of stock which is said to have transferred control of ISI, because the Trust Fund acquired its own Board of Directors in September 1956 (see pp. 13, 71, *supra*).

"In the case of a registered management company which is an unincorporated company not having a board of directors * * *."[53]

This illustrates again that the Act was written with unusually detailed precision. If Congress had intended to apply Section 36 to directors of a service corporation it would have explicitly said so, just as it did when it wished to make Section 10 applicable. Section 36 now contains two subdivisions specifying the persons to whom it applies, viz.:

"(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

"(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company."

It would have been easy to add a subdivision (3) to specify

"Or as officer, director, or member of an advisory board of the investment adviser or depositor in case the registered investment company is an unincorporated company not having a board of directors."

As said in *Addison v. Holly Hill Co.*, 322 U.S. 607, 614:

"Where Congress wanted to make exemption depend on size, as it did in two or three instances not here relevant, it did so by appropriate language. Congress referred to quantity when it desired to legislate on the basis of quantity."

4. Directors of a service corporation are not directors of the investment company.

Finally, in a sort of desperation, appellant argues (Br. 100) that the directors of ISI are to be deemed directors of the Trust Fund. This argument is an afterthought. The complaint does not allege that the director-defendants are directors of the Trust Fund. On the contrary it alleges that "the Trust Fund has no officers or

53. "Management company" means "investment company" by reason of a definition in Section 4(3).

directors of its own" (R. 6, para. 8). It further alleges that the individuals are officers and directors of ISI (R. 4, para. 2). Nor does it allege that the director-defendants perform the functions of directors of the Fund. On the contrary, it alleges (R. 6, para. 8) that "management functions are discharged by Insurance Securities as Sponsor, Investment Adviser of said Trust Fund."

Appellant rests this new contention on Section 2(a)(12) which defines a "director" as "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member of a board of trustees of a management [i.e., investment] company created as a common law trust." But the plain meaning of Section 2(a)(12) is that any employee of an organization who performs for that organization any of the duties that would be performed by *its* board of directors if it had a board shall be deemed a director. The section does not extend the definition of director beyond the organization by which the individual is employed.

If Section 2(a)(12) had the meaning which appellant would assign to it, it would have been unnecessary for Congress to enact subsection (h) of Section 10 (discussed, p. 90, *supra*) in order to make Section 10 applicable to directors of the adviser where the investment company is unincorporated and has *no* directors.

Section 2(a)(12) defines a director and Section 2(a)(3) defines an "affiliated person".[54] Under subdivision (D) of Section 2(a)(3), a director is an "affiliated person" of the company of which he is a director; under subdivision (E) the investment adviser is an "affiliated person" of an investment company. Under subdivision (F), in case of "an unincorporated investment com-

54. Section 2(a)(3):
"'Affiliated person' of another person means * * * (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

pany not having a board of directors, the depositor thereof" is an affiliated person. Thus the director of a service corporation is an affiliated person of that corporation, but by definition he is not an affiliated person of the investment company which it serves, as he would be if Section 2(a)(12) were construed to treat him as a director of the investment company. Congress was precise in its definition. The director of a service corporation serving an unincorporated investment company having no board of directors of its own is not a director of the investment company. He is a director of an affiliated person of the investment company. He is reached, for example, under Section 17, as an affiliated person of an affiliated person.

This is well illustrated by the passage from Senate Report No. 1775, quoted at p. 88, *supra,* which we repeat:

> "In the future, persons who are officers, directors, investment advisers, etc., *or persons affiliated with such persons* may not, as principal, knowingly sell to or purchase from any investment company * * * (sec. 17)"

To summarize: Congress might have provided that directors of a service corporation are to be deemed directors of the investment company which it serves, if the latter has no directors of its own. But Congress did not. On the contrary, it first recognized that there may be unincorporated investment companies not having a board of directors, it provided that they may be served by an investment adviser having the duty to select the securities to be bought and sold; and, having so provided, instead of saying that the directors of a service corporation are affiliated persons of an unincorporated investment company having no board of directors—which a director would be—it provided that the service corporation is the affiliated person of such an unincorporated investment company.

In Section 36, Congress is precise in naming the persons to whom it should apply, just as it is in Section 9, referred to by appellants. As has been seen, while the Act is detailed, the various sections dovetail perfectly.

II.

THERE HAS BEEN NO TRANSFER OF A CONTROLLING BLOCK OF STOCK IN ISI

As already noted (p. 9, *supra*), appellant does not contend that *all* sales of stock in a *service corporation* for more than its physical asset value would constitute "gross abuse". An essential ingredient of the contention is that there be a sale of a "controlling stock interest" (e.g., Br. 68).

Thus far our brief has proceeded on the assumption that there was such a sale. We now submit, further, that this is not a fact. This issue the District Court did not decide, stating (R. 146):

> "The Court finds it unnecessary to decide the question whether under the complaint's allegations the sale by the four named individual defendants was a transfer of a controlling stock interest in Service Company, inasmuch as decision on the motion to dismiss will be based upon the fundamental issue as to whether the statute otherwise authorizes this cause or the remedy sought."

But if a decision below is correct on any ground supported by the record, it must be affirmed, regardless of the ground on which the lower court relied. *Helvering v. Gowran,* 302 U.S. 238, 245; *Oklahoma v. Civil Service Commission,* 330 U.S. 127, 134.

A. The facts about the sales: No person sold and no person acquired 25% of the stock.

The term, "controlling block", requires reference to Section 2(a)(9) of the Act, quoted at p. 9, *supra*. It provides that one who owns more than 25% of the voting securities shall be presumed to control a company and one who does not own more than 25% shall be presumed not to control it. These presumptions are conclusive in this case.[1]

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1. Section 2(a)(9) provides further that

"Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested party".

No such determination was ever made or sought.

The undisputed facts are that no one stockholder owned as much as 25% of ISI's stock. Each of the four defendants, Leach, Lonergan, Carr and Haight, owned 30,000 shares or 18% (R. 7, para. 14). In February 1956, each sold 8,000 shares (or 4.8% apiece of the outstanding shares), through Leland M. Kaiser, an investment banker, as did another stockholder who is not a defendant (E. Smith). One D. D. Harrington bought 10,000 shares, and three insurance companies, affiliated with each other and called the Life Group, bought 10,000 shares each (R. 56, 64, 70, 72, 75, 81, 83).

In May each of the four individual defendants, Leach, Lonergan, Carr and Haight, sold another 5,000 shares (or 3% each of the total outstanding shares). These 20,000 shares, plus 1,000 sold by another stockholder who is not a defendant, were bought by Richardson & Bass (R. 58, 64, 65, 70, 73, 75) and later split between Mr. Richardson and Mr. Bass (R. 85)[2]. In July Leach contracted to sell another 16,000 shares (or 9.6% of the outstanding shares) which Harrington agreed to buy (see p. 8, *supra*).

As consideration for the services of Mr. Kaiser as investment banker in arranging the various sales, Kaiser & Co. obtained beneficial interests in some of the shares of stock and the absolute power to vote 17,600 shares (R. 59, 60).

Thus no one of the four defendant stockholders sold, on any occasion, anywhere near 25% of ISI's stock, and no one sold as much as 25% even in the aggregate. Conversely, in no purchase did any buyer acquire any more than a small fraction of 25% of the outstanding ISI stock. And no purchaser bought as much as 25% in the aggregate.

After consummation of the last transaction the situation was as follows:

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2. In the same month, Harrington in a series of purchases from 4 other stockholders bought 11,000 shares. Since the sellers were not directors of ISI, these purchases have no relation to the alleged charge of an abuse of trust and the sellers were not joined as defendants. (R. 58)

Sales	
By Leach	29,000 shares or 17.4% of those outstanding
By Lonergan	13,000 shares or 7.8% of those outstanding
By Carr	13,000 shares or 7.8% of those outstanding
By Haight	13,000 shares or 7.8% of those outstanding

Acquisitions			
Life Group	had become the absolute owner of and entitled to vote	24,000	shares or 14.5% of those outstanding
S. W. Richardson	had become the absolute owner of and entitled to vote	8,800	shares or 5.3% of those outstanding
Perry R. Bass	had become the absolute owner of and entitled to vote	8,000	shares or 4.8% of those outstanding
D. D. Harrington	had become the absolute owner of and entitled to vote	29,600[3]	shares or 17.8% of those outstanding
Kaiser & Co.	beneficial interest and right to vote	17,600	shares or 10.6% of those outstanding

B. The situation must be examined from both the sellers' side and the buyers' side.

The question of "controlling block" must be looked at from both the sellers' side and the buyers' side. Did any seller own and sell more than 25% of ISI stock? Did any buyer buy more than 25%?

Plainly both elements must exist. Under appellant's theory, the alleged "gross misconduct" or "gross abuse of trust" is that of the person who sells, not of him who buys. If, by a series of purchases of stock from concededly separate sellers each of whom owned only 1%, a buyer should finally aggregate control, the last purchase of one share could not convert into wrongdoers all the previous sellers who theretofore were innocent and make a wrongdoer of the seller of the last share as well. Consequently, there must be a sale of a controlling block by someone who owns it.

But, conversely, if one who owns a controlling block sells it piecemeal in blocks of 1% to a series of buyers, no one has bought control, the seller has not sold a controlling block to anyone, and

3. Of which more than 1/3 was bought from non-defendants.

thus the basic predicate of appellant's theory would be lacking (see App. Br. 68, 69).[4]

C. Allegation of the complaint.

It is obvious, from the facts stated above, that no seller either owned or sold, and no buyer bought, a controlling block, unless all sellers are treated as a unit and all buyers as a unit. The only allegation in the complaint possibly bearing on that subject is this (R. 8, para. 16):

> "Upon information and belief, on or about February 1, 1956, the director-defendants, either alone or in concert with others, embarked upon a plan to sell their stock interests to a small number of purchasers, affiliated among each other through stock ownership or otherwise."

This allegation, and the facts underlying it, must be examined both from the buyers' side and the sellers' side.

D. The situation from the sellers' side.

The allegation is that Leach, Lonergan, Carr and Haight "either alone or in concert *with others* embarked upon a plan". In the first place, this is not an allegation that they acted in concert *with each other*.

Second, in their affidavits these defendants denied that they acted in concert or embarked on any plan (R. 63, 69, 72, 74). It has long been held in this Court that affidavits may show an allegation to be sham, and that if the affidavits are uncontradicted, the pleading stands pierced. *Koepke v. Fontecchio,* 177 F.2d 125 (9 Cir.); *Gifford v. Travelers Protective Assn.,* 153 F.2d 209 (9 Cir.); *Lindsey v. Leavy,* 149 F.2d 899 (9 Cir.). Appellant sub-

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4. Whether, in any of these circumstances, there would be a sale of a controlling block so as to terminate the service contract and require a new contract may or may not be another question, which is not relevant here. But the statement above is patently correct so far as the theory of "gross abuse of trust" under Section 36 is concerned.

mitted no affidavits or showing tending to the contrary, but merely argues that a judgment cannot be based on the affidavits of a *moving party,* though uncontradicted, if the relevant facts are within his *sole* knowledge. We think this is unsound law and not in accord with the decisions of this Circuit.[5] But, were it assumed to be sound law, that is by no means the end of the matter, and for two separate reasons.

First: The allegation of a plan has no significance. Appellant argues (Br. 89) that "if Section 36 applies when one person transfers control by a sale of more than 25% of the stock, it is equally applicable when control is transferred by a group of persons in the same aggregate amount pursuant to a plan." Thus, having first stretched Section 36 to regulate a sale of a controlling block of stock by a single director-stockholder, appellant would extend it again to say that sales by several, none of whom owns a controlling block, are to be treated as sale by one. No authority is

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5. In *Kam Koon Wan v. E. E. Black, Ltd.,* 188 F.2d 558 (9 Cir.) this Court affirmed a summary judgment on the basis of uncontradicted affidavits showing movant's good faith.

Appellant cites in support of its assertion *Toebelman v. Missouri-Kansas Pipe Line Co.,* 130 F.2d 1016 (3 Cir.) and Judge Frank's opinion in *Subin v. Goldsmith,* 224 F.2d 753 (2 Cir.). *Subin v. Goldsmith* relates merely to a situation where the material fact is the state of mind of a party. The decision may be sound where that party has the burden of proof on the issue, for the opponent is entitled to cross-examine to test credibility. If the party is disbelieved, his case will fail for want of proof. But this reasoning does not apply where affiant does not have the burden of proof. One who has the burden of proof does not establish his case by cross-examining his opponent and asking the court to disbelieve him. *Walsh v. American Trust Co.,* 7 C.A. 2d 654, 660, 47 P.2d 323; *Stewart v. Silva,* 192 Cal. 405, 411; 221 Pac. 191; see *Moore on Facts,* Sec. 131, pp. 177, 178 on "Effect of Disbelieving a Witness"; *Dyer v. MacDougall,* 201 F.2d 265 (2 Cir.). He must offer his own proof, and in opposing a motion for summary judgment must show that he has such proof to offer.

The *Toebelman* case turned on lack of adequate opportunity of the party opposing the motion to gather a showing (p. 1022, 2d col.). Moreover, the third circuit is notoriously out-of-step on the subject of summary judgments. (See note under Rule 56 in "Preliminary Draft of Proposed Amendments to Rules of Civil Procedure for the United States District Courts, prepared by the Advisory Committee on Rules for Civil Procedure", May 1954.)

cited for this claim.[6] It challenges the definition of "controlling block" in Sec. 2(a)(9) of the Act, and the conclusiveness of the presumption created by that section.

Moreover, it defies the fact that when Congress wished to attach consequence to an action "*in concert* with other persons", it knew how to say so explicitly (Sec. 2(a)(29)).[7]

Second: Appellant's argument looks at the sales only from the *sellers' side* and does not touch on the buyers' side.

E. The situation from the buyers' side.

The fact that the stock was transferred to 7 buyers is an uncontradicted *objective* fact. It does not rest either *in state of mind* or *in the sole knowledge of any party.*

While paragraph 16 of the complaint alleges that the sellers planned to sell to buyers "affiliated * * * through stock ownership or otherwise", there is no allegation that when the sales were made, the 7 buyers were so affiliated. But let us assume that the allegation was merely inept.

Stock ownership is an *objective* fact, not involving state of mind. The affidavits concede that the three members of the Life Group are affiliated with each other. But their acquisition totals only 14½%. The affidavits *of the buyers,* none of whom is a party to this cause, also establish that the other purchasers are *not*

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6. The only case cited by appellant is *Pepper v. Litton,* 308 U.S. 295, 311. The Supreme Court said of it, in *Securities and Exchange Commission v. Chenery Corp.,* 318 U.S. 80, 89:

> "The only question in *Pepper v. Litton,* 308 U.S. 295, was whether claims obtained by the controlling stockholders of a bankrupt corporation were to be treated equally with the claims of other creditors where the evidence revealed 'a scheme to defraud creditors reminiscent of some of the evils with which 13 Eliz. c. 5 was designed to cope.' "

7. Sec. 2(a)(29) provides:

> " 'Promoter' of a company or a proposed company means a person who, *acting alone or in concert with other persons,* is initiating or directing," etc.

affiliated by stock ownership.[8] There is no contradictory affidavit. Thus the *objective* facts, *uncontradicted,* not resting on the affidavit of any party to the cause, pierce *as sham* any allegation that the buyers were affiliated by stock ownership so as to constitute single ownership of a controlling block.

As for an allegation that the buyers were "affiliated otherwise", this is a meaningless expression. Sections 2(a)(2) and (3) of the Act define the term "affiliated".[9] So defined, it requires ownership of voting securities by one in the other, or by a common parent, or else occupation of an office by one in, or employment by, or a partnership with, the other. The affidavits of non-parties establish, without contradiction, that in no sense given by the Act were any of these buyers affiliated with others (other than the Life Group *inter se*).

Appellant nowhere states what it means by "affiliated otherwise" or how it conceives that an "affiliation otherwise" would be significant. Was it intended to mean merely that the buyers have an agreement with each other to act as a unit? If so, each buyer has filed an affidavit that he entered into no such agreement (R. 82, 84, 86, 87). There is no contradicting affidavit and no docu-

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8. Affidavit of Harrington, R. 81; of John D. Murchison, R. 83; of Richardson, R. 85; of Bass, R. 87.

9. They provide:

"(2) 'Affiliated company' means a company which is an affiliated person.

"(3) 'Affiliated person' of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

ment from which any contrary inference can be drawn. The affiant-buyers are not defendants, and the alleged rule about state of mind of an adverse party does not apply.

F. The irrelevance of the affidavits filed by appellant.

Mr. Kaiser is an investment banker, and it has been part of his profession to find buyers for securities seeking buyers and opportunities for capital seeking investment. His attention was first drawn to ISI largely by the fact that its president, the defendant Leach, was over 80 years old. It occurred to Mr. Kaiser that, in the due course of events, the Leach stock would be offered for sale. He therefore approached Mr. Leach, who first stated that he was not interested in selling, but on a later approach stated that he would sell none of his stock unless an opportunity were given to other stockholders to sell theirs (R. 56).[10]

Appellant reviews these facts and notes that the possible sale of ISI stock was first brought to the attention of the Commission's staff in September 1955 (Br. 7). About this time Mr. Leach, through his attorney, Mr. Elwood Murphey, learned of the Commission's view which it seeks to enforce in this lawsuit. As appellant notes, Mr. Murphey called on the Commission's staff to discuss the matter, and Mr. Kaiser had correspondence with the Commission on the subject and disagreed with its interpretation of Section 36 (App. Br. 7, 8).

All this is true. But it is irrelevant. The Commission's views having been learned, consultation was had with counsel.[11] The views of an administrative bureau do not make the law, and it is the privilege of free-born citizens to disagree.

Appellant then asserts, at various points, that the sales were cast in the form of separate, successive transactions (App. Br. 7)

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10. Mr. Leach was thus faithful to a standard of ethics higher than equity requires.

11. Mr. Jaretzki's intimate knowledge of the Act and its origin have been pointed out at p. 36, *supra.*

and insinuates that this was done as a mask or a subterfuge to avoid transferring "control", calling the separate sales "stage props" (Cf. App. Br. 82). But terms like "evasion" and "stage props" are mere epithets and evince a disregard for some elementary principles of law.

While defendants disagreed with the Commission's views that a sale of a controlling block of stock in the Service Corporation would constitute "gross abuse of trust" toward the Trust Fund, nevertheless no one wishes to engage in controversy with a government bureau if it can be avoided, for to be pursued by it by fire and sword is a great burden both in expense and in other ways.[12] For example, defendants have been accused of "gross abuse of trust" with the wide-spread publicity always given charges made by government bureaus. This harmful publicity has hardly been mollified by the explanation that the term "gross

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12. As a consequence, too often people succumb to the views of bureaus although convinced they are in error. Such may be the fact in the "uncontested case" of one Gardiner which appellant exhumes from its files and reviews (Br. pp. 78, 79). Appellant states that Gardiner owned 50% of the stock of Management Associates which performed services for Incorporated Investors, that he died, and his executors turned in his stock in Management Associates to that corporation itself for redemption at net asset value. What bearing this has on the present case escapes us. When Gardiner died, his executors occupied no office in either Incorporated Investors or Management Associates, and so a sale by them could not fall under Section 36 even under appellant's theory. Moreover, there is nothing to show that anyone was willing to pay more than asset value, or that there was any opportunity to sell other than by redemption. Appellant asserts that "the parties and the Commission agreed that, since the contract is nonassignable, no value may properly be attributed to it for the benefit of the selling stockholder or his estate." This is a gratuitous assertion; the Commission's releases, Nos. 1911 and 1947, to which appellant refers contain no verification of the assertion. But even if it were a fact, it would be worthless in interpreting Section 36. The releases show no more than this: If Gardiner's death constituted a transfer of the stock to his estate, the service contract ended. Exemption from the need of getting a reinstatement from the investors for a period of time was sought and obtained under Section 15(a) of the Act "because of the *possible* assignment of the investment advisory contract that resulted when [the] shares * * * were transferred by operation of law to the estate of * * * Gardiner at the date of his death * * *." (Release No. 1947.)

abuse of trust" is used by the Commission in this case in a Pickwickian sense and does not mean mismanagement, embezzlement, or waste of the assets of the Trust Fund (see pp. 7, 11, *supra*). In the hidden recesses of its brief on appeal (p. 80) appellant concedes that

> "We are not suggesting that the new controlling interests in ISI will abuse their fiduciary position with respect to the Trust Funds."

But no such disclaimer ever comes to the attention of an investing public or ever catches up with the first publicity blast. The investors see only the foul words, "gross abuse of trust".

In these circumstances each individual defendant decided that he would make no sale that would enable any purchaser to acquire a controlling block. The options which each gave to Mr. Kaiser stated explicitly that he, as the investment banker, must find buyers such that no one would acquire as much as 25% (App. Br. 9).

Appellant insinuates that this was "evasion". But it is not "evasion" of the prohibitions of a law to avoid doing what the law prohibits and to do instead what it does not prohibit. As Mr. Justice Holmes frequently admonished:

> "We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits." *Bullen v. Wisconsin*, 240 U.S. 625, 630.

So also: *Superior Oil Co. v. Mississippi*, 280 U.S. 390, 395 (per Holmes, J.); *United States v. Isham*, 17 Wall. (84 U.S.) 496; *Iowa Bridge Co. v. Commissioner*, 39 F.2d 777, 781 (8 Cir.); *Seeman v. Philadelphia Warehouse Co.*, 274 U.S. 403.[13]

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13. *In re George Inglefield, Limited* (1933) 1 Ch. 1, the Court of Appeals of England said:

> "It is not a question of evasion. A transaction is either within or without the law, and malice is not to be attributed to a person who

We deny that sale of a "controlling block" of stock in ISI at any price would violate Section 36 of the Act. And the District Court so held. We further deny that a controlling block was bought or sold. And if it be a fact that the sale of a "controlling block" was avoided in order to avoid conflict with the Commission's notions of the law, that would not constitute "evasion".

We submit that the complaint did not allege the sale of a controlling block. We further submit the uncontradicted showing that there was no such sale. It was incumbent on appellant to meet this showing by *facts,* not by insinuation and epithet. It did not do so.

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so carries out a transaction that it remains outside the law. (pp. 22-23)

* * * * * * *

"If a man so conducts his affairs that he places himself outside the operation of an Act of Parliament he cannot be said to be either evading it, or defeating it. He has done nothing that is unlawful, and he has done nothing that calls for adverse comment from the Court." (p. 26)

In *Yorkshire Railway Wagon Company v. Maclure,* 21 Ch. Div. 309 (1882), Jessel, M. R., commented:

"Thereupon, like sensible men, they consulted their solicitors, and their solicitors, like sensible men, took the opinion of eminent counsel. * * *" (p. 312)

It was further said:

"* * * It is said to be an evasion of the Act of Parliament really to borrow the money. There is always an ambiguity about the expression 'evading an Act of Parliament.' In one sense you cannot evade an Act of Parliament; that is to say, the Court is bound so to construe every Act of Parliament as to take care that that which is really prohibited may be held void. On the other hand, you may avoid doing that which is prohibited by the Act of Parliament and you may do something else equally advantageous to you, which is not prohibited by the Act of Parliament." (p. 319)

PART TWO OF THE ARGUMENT

Count Two States No Claim for Relief

Since appellant concedes that Count Two fails with Count One (see p. 15, *supra*), we could leave Count Two with our submission of Count One. However, Count Two possesses its own deficiencies, and those going to the merits illustrate the extreme nature of the Commission's contentions and help to appraise its approach to the whole case. We therefore discuss the subject briefly.

I.

COUNT TWO IS MOOT

If the proxy statement were misleading, the basic wrong was to solicit the proxies, and the primary remedy was to enjoin the solicitation. An injunction against the use of proxies, after they have been obtained, is itself an extension of the remedy which occasioned no little doubt when first asserted in *Securities and Exchange Commission v. Okin,* 58 F. Supp. 20, 21.[1]

Yet here the proxies have been voted (pp. 13, 15, *supra*). When a trial court dismisses a complaint seeking an injunction, and the object sought to be enjoined is accomplished before or pending appeal, the cause is moot. *Wingert v. First National Bank,* 223 U.S. 670; *Love v. Griffith,* 266 U.S. 32; *Arkansas & Louisiana Missouri Railway Co. v. Amarillo-Borger Express, Inc.,* 352 U.S. 1028.

Apparently appellant now wishes to push the remedy farther than any court has ever gone, although it does not specify exactly what it does seek (Br. pp. 110, 111). It states (Br. 111):

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1. The court there said:

"This case, however, goes a step farther than any of the cases cited above or any other case to which my attention has been called. Here it is sought to restrain, not only the making of false or misleading statements, but also to restrain the use at the annual meeting of proxies obtained by defendant as a result of sending out any statement which is held to be violative of the rules mentioned."

> "The Commission's motion for a preliminary injunction was withdrawn upon the understanding, as set forth in the Second Interlocutory Order, that it was without prejudice to the power of the court to grant appropriate relief, 'including any action with respect to the Investment Advisory and Principal Underwriting Contracts, whether or not approved by Investors in the Trust Fund, if it is determined in a final decree that plaintiff is entitled to judgment' (R. 95)."

This was merely a statement that by entering the stipulation the Commission did not waive the right to seek any relief still within the power of the Court to grant; it was not a waiver by defendants of the right to contend that no relief could be granted. The stipulation neither subtracted nor added to the Court's power.

Moreover, the relief sought could only be an injunction against operation under the new service contract effected by the vote of the proxies. But this too is moot, because appellant seeks the same relief under Count One. If Count One is bad, Count Two concededly fails. If appellant is correct in its contentions with respect to Count One, Count Two is now pure superfluity.

Count Two is thus deadwood.

II.

ON THE MERITS AND APART FROM COUNT ONE, COUNT TWO STATES NO CLAIM FOR RELIEF.

A. The proxy statement and the proxy rule.

Section 20(a) of the Act provides that it shall be unlawful for any person to solicit any proxy in respect of a security issued by a registered investment company

> "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Under this section the Commission promulgated its Rule N-20A-1 which adopted its proxy rule issued under the Securities Exchange Act. That rule (17 C.F.R. 240.14a-9) reads:

"No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, *or which omits to state any material fact necessary in order to make the statements therein not false or misleading* or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading."

The issue is whether the proxy statement violated this proxy rule. The proxy material is Exhibit B of the complaint (R. 18-47), and the only pertinent passage is this statement (R. 33):

"Mr. Leach now proposes to retire as the chief executive of the Company and will assume the less active role of Chairman of the Board. At the same time he advises us that he is selling substantially all of the balance of the stock of the Company which he holds, amounting to 10.24% of the stock of the Company, to other stockholders of the Company. Upon the consummation of this sale, the old stockholders of the Company, being those who have held stock for over 16 years, will hold less than a majority of its shares, to be precise 45.78% thereof, and the Company is advised that *this change in majority ownership may be considered an assignment of the contract between the owners of the Trust Fund* and the Company concerning matters of Investment Advising and Principal Underwriting, as defined in the Investment Act of 1940. Under the terms of such contract and such Act, *a termination of the contract takes place upon its assignment.*"

The proxy rule, it will be seen, prescribes that a proxy statement may be misleading and false in two respects:[2]

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2. Appellant's brief (p. 104) correctly notes a third respect, omission to state a fact necessary to correct a false statement in an earlier communication. But there were no earlier communications involved in this case, and appellant mentions none.

1. In affirmatively stating a material fact that is false or misleading; and

2. In omitting "to state any material fact necessary in order to make the statements therein not false or misleading."

The complaint seems to claim one affirmative statement of a false or misleading fact and three items of omission.

B. The alleged misstatement is no misstatement at all.

Paragraph 28 of the complaint alleges (R. 12):

> "In the proxy statement it is alleged that the 'company is advised' that the 'change in majority ownership' of Insurance Securities stock 'may be considered an assignment' of said contracts by the terms of the contracts and under the Act. The Commission alleges that under the facts and circumstances here presented such contracts have been terminated."

The passage quoted above from the proxy statement said that the events "may be considered an assignment" and that "a termination of the contract takes place upon its assignment". Apparently the contention is that the proxy statement was misleading in not stating that the contract *had* terminated!

Here is a situation where the company soliciting the proxy has in effect said to the investors: "We seek a reinstatement of the contract, and we are putting it to your vote for the simple reason that it may have terminated." This is no different in any relevant sense from a statement that "We seek reinstatement of a contract because it has terminated." In either event the action taken by the solicitor of the proxies and the action sought of those solicited proceeds *as if* the contract had terminated. The solicitation states, in effect, that reinstatement is sought because for the sake of caution ISI does not want to proceed on the basis that the contract is still in effect. The investors' vote would not have been influenced by stating the matter one way instead of the other.[3]

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3. In *Phillips v. The United Corporation,* Federal Securities Law Reporter, '45-'47 Dec. para. 90,395, the court said, p. 91,072:

> "In *S.E.C. v. Okin,* 58 F. Supp. 20 (S.D. N.Y. 1944) the Court noted that the statement or omission claimed to be misleading must be such as would have influenced the stockholder's vote."

Appellant's claim as expressed in the complaint is that the proxy statement was misleading in not adopting its position in this suit on the issue of whether a "controlling block" of stock was sold. But appellant's brief does not discuss the charge made in paragraph 28 of the complaint. Instead it asserts (Br. 105):

> "Also, the ISI proxy letter sent to investors in the Trust Fund stated that the change in control of ISI may have 'the technical effect' of terminating ISI's investment advisory and principal underwriting contracts with the Trust Fund. * * * it was false and misleading to characterize such effect as merely 'technical'."

This refers to the following passage in the covering letter by which the proxy statement was sent to the investors (R. 21):

> "In connection with Mr. Leach's semi-retirement, he is selling substantially all of his stock of the Company to other stockholders. As explained in the Proxy Statement, this sale, together with other sales of stock made in the past, may have the technical effect of terminating the Investment Advisory and Underwriting Contracts of the Company under the Trust Agreement. Therefore, these contracts are submitted to the investors for reinstatement."

But neither in the original complaint nor in the amended complaint did Count Two charge that the use of the word "technical" was misleading. Appellant thus abandons the accusation of the complaint and seeks to substitute another by its brief. Moreover, appellant's quotation of the passage from the proxy letter where the word "technical" is used is itself a misleading half-quote. The statement was preceded in the proxy letter by the words, "As explained in the Proxy Statement * * *" (R. 21). The latter went into the matter in detail and did not contain the word "technical".

But apart from all this, to assume that the use of the word "technical" was misleading is not only an afterthought but frivolous.

Leach, Lonergan, Haight and Carr sold 68,000 shares or 40.8% of all outstanding. If taken in the aggregate, this was "control" within the meaning of the Act because it is more than 25%. But these four individuals continue to own 52,000 shares, or 31-1/3%, which is also "control" within the meaning of the Act. Thus, even if they transferred control, they still have it, and having "transferred" it once, they could "transfer" it again! In the circumstances the adjective "technical" is wholly apt. In any event its use was not misleading.

C. The "alleged omissions boil down to nothing at all".

The other alleged violations of the proxy rule are all omissions. As appellant sums up its contention (Br. 104, 105): "the proxy material * * * was false and misleading in that it failed to disclose material facts." But in the language of *Subin v. Goldsmith*, 224 F.2d 753, 775 (2 Cir.), the "alleged omissions * * * boil down to nothing at all."

Paragraph 30 of the complaint (R. 12) claims that the proxy statement should have added that "the company has also been advised by the staff of the Commission that, on the facts presented, the change in majority ownership may also involve gross misconduct and gross abuse of trust under Section 36 of the Act."

Paragraph 31 (R. 13) claims that the proxy statement should have stated the price at which the defendants Leach, Lonergan, Carr and Haight had sold their stock in ISI.

The last item of alleged omission is an afterthought upon an afterthought, not in the original complaint, but added to paragraph 31 by amendment (R. 47). As amended, that paragraph charges that the proxy statement was misleading in not stating the "net book value" per share of ISI stock and the profit which the director-defendants made or would make on the sale of their stock.

Appellant does not contend (Br. 109) that there was any "outright falsehood", or "ambiguous statement deliberately contrived",

in other words, any half truth, or that *any of the omitted items was "related to some affirmative statement or representation already contained in the proxy statement".* The passage in the proxy statement, quoted above, states that Leach was selling substantially all his remaining stock, amounting to 10.24% of that outstanding, to other shareholders, that upon consummation of the sale the old shareholders would hold less than a majority, and that this change in ownership might terminate the contract. The claimed omissions simply have no relation whatever to any of these statements. Admittedly, there are *no affirmative allegations in the proxy material, singly or as a whole, which became misleading because of the absence of any of the sentences which appellant contends should have been included.*

Appellant merely claims that there was a "failure to disclose material information", blandly asserting that the "purpose of the Proxy Rules is to require full disclosure of material information." (Br. 104, 108, 109).

This argument fails for two separate reasons, which we briefly consider.

1. Appellant misinterprets the proxy regulation.

The proxy rule, which is quoted above, does *not* require the proxy solicitation to contain data which the SEC thinks the recipient should know. It does *not* provide that "failure to disclose material information" is a violation. *The requirement is that the proxy statement should not omit a fact necessary to prevent affirmative statements from being misleading. This is the plain language of the rule.* English can be no plainer, simpler, less equivocal, or less requiring construction. Thus, in *Securities and Exchange Commission v. Okin,* 58 F.Supp. 20, the court said that the rule

> "require[d] a statement of material facts necessary to make the assertions therein not false or misleading". (p. 21)

Since the SEC was empowered by Congress to lay down proxy rules, possibly it could have laid down a broader rule than it did.

But it did not do so. And until it has done so, it can only invoke the rule which it has adopted within its delegated power. *Tobin v. Edward S. Wagner Co.*, 187 F.2d 977 (2 Cir.).[4]

The language of SEC's proxy rule is similar to the language of Section 49 of the Act (15 U.S.C. § 80a-48) which provides:

> "* * * or any person who wilfully in any * * * document * * * makes any untrue statement of a material fact *or omits to state any material fact necessary in order to prevent the statements made therein from being materially misleading in* the light of the circumstances under which they were made, shall upon conviction be fined * * * or imprisoned * * * or both * * *."

The language in the proxy rule and in the statute being similar, they must receive the same interpretation. *F.C.C. v. American Broadcasting Co.*, 347 U.S. 284, 296. And since the statute is penal, no latitudinarian interpretation is possible.

Appellant (Br. 109, 110) cites two cases, one dealing with an analogous but not identical regulation[5] and the other with a common law situation.[6] Both cases are cited in the discussion of

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4. The court there said:

> "* * * when the legislature delegates to an administrative official the authority, by 'sublegislation,' to issue regulations * * *, then the regulations, precisely because they particularize, ought not to be as generously interpreted as the statute. In fairness to the regulated, the provisions of the regulations should not be deemed to include what the administrator, exercising his delegated power, might have covered but did not cover" (p. 979).

5. In *Hughes v. Securities and Exchange Commission,* 174 F.2d 969. Hughes was an investment adviser. When she advised a client to buy a particular stock, she would sell it to the client from her own holdings or would buy it on the market to resell to him. While she informed the clients that she would act as "principal" in every transaction she recommended, she did not tell them the nature and extent of her adverse interest in the transaction *with them;* for example, she did not tell them that they could purchase the stock more cheaply if they bought it in the open market rather than from her. The case is thus also a case of sales and dealings *between fiduciary and beneficiary*, while the present case is not.

6. *Equitable Life Ins. Co. v. Halsey, Stuart & Co.,* 312 U.S. 410.

the subject in the leading treatise—*Loss, Securities Regulation*—which concludes:

> "But those provisions are still limited to *half-truths*[7] as distinct from complete omissions to disclose anything. They do not require the seller 'to state every fact about a stock offered that a prospective purchaser might like to know or that might, if known, tend to influence his decision.' " (p. 819)

Loss cites *Otis & Co. v. Securities and Exchange Commission,* 106 F.2d 579, (6 Cir.) where the court states of analogous regulations (p. 582):

> "The statute did not require appellant to state every fact about stock offered that a prospective purchaser might like to know or that might, if known, tend to influence his decision, but it did require appellant not 'to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.' "

S.E.C. Regulation X-14 (17 C.F.R. 240.14) requires *certain* data to be *affirmatively* stated but otherwise directs itself to the prohibition of misleading statements. Apart from the affirmative data thus required, proxy material would not have to contain any statements at all. Common sense tells us why the SEC has never framed a rule requiring the affirmative inclusion of "material" facts. The number of facts which could be claimed to be material to any question would be endless. Only the breadth of human imagination could place boundaries on what might be thought to influence the decision of at least one person asked to give his proxy. Under such a requirement every proxy statement would have to be a book of pros and cons, for there is nothing easier than to excogitate, *ex post facto,* that some fact or other would have been material.

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7. Appellant's quotation (at Br. 110) from the *Hughes* case itself refers to the "telling of half-truths".

Since private parties as well as the Commission can sue for violation of the proxy rules (*Textron, Inc. v. American Woolen Co.*, 122 F. Supp. 305, 308), appellant's present interpretation of the rule could open up a pandora's box of litigation between intra-corporate factions in the proxy battles not infrequent in business today.

2. Moreover, the so-called omitted facts were not material.

The term "material" requires reference to something. Here, it is the question whether the investors wished to reinstate the servic contract. The only train of reasoning by which appellant argues "materiality" is (Br. 109):

> "When asked for their consent [to the reinstatement of the contract], investors are entitled to appraise whether the recommendations of the management are disinterested or moved by considerations of personal gain."[8]

But it was self-evident to the investors that reinstatement of the contract was to the interest of ISI; that is why ISI sent out the proxies.[9] Moreover, the price paid to the selling stockholders and the profit made *by them,* from the sale, had no bearing on whether reinstatement of the contract was to ISI's advantage and no bearing on the measure of the advantage. If anything would be material to *such* matters, it would be the fees paid *to* ISI for the service rendered. This *was* stated in the proxy solicitation material (R. 29, 30, 31, 32).

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8. Neither the selling stockholders nor buyers made any "recommendation" at all. ISI, the corporation, merely indicated that it favored a yes vote, but it sent out no arguments or "sales talk" in favor of approval. (R. 46)

9. The case is wholly unlike *Dunnett v. Arn,* 71 F.2d 912 (10 Cir.), cited by appellant. That case did not arise under any statute or regulation but involved a common law question. The holders of a majority of stock made a deal to sell all the stock to the buyer so that it could acquire the corporate assets, sold their own shares at a certain price and falsely implied to the other stockholders that they had sold for less in order to induce the latter to do likewise.

CONCLUSION

Paraphrasing *Helvering v. Sabine Trans. Co.,* 318 U.S. 306, 311, the contentions of the Commission "are in the teeth of the unambiguous mandate of the statute, are contradictory of its plain terms, and amount to an attempt to legislate."

We respectfully submit that this Court should lend it no hand, and that the judgment of dismissal should be affirmed.

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